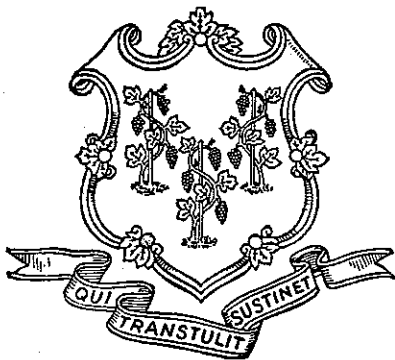


Department of Banking

Connecticut General Assembly



LEGISLATIVE PROGRAM REVIEW AND INVESTIGATIONS COMMITTEE

January 1993

CONNECTICUT GENERAL ASSEMBLY LEGISLATIVE PROGRAM REVIEW AND INVESTIGATIONS COMMITTEE

The Legislative Program Review and Investigations Committee is a joint, bipartisan, statutory committee of the Connecticut General Assembly. It was established in 1972 to evaluate the efficiency, effectiveness, and statutory compliance of selected state agencies and programs, recommending remedies where needed. In 1975, the General Assembly expanded the committee's function to include investigations, and during the 1977 session added responsibility for "sunset" (automatic program termination) performance reviews. The committee was given authority to raise and report bills in 1985.

The program review committee is composed of 12 members. The president pro tempore of the senate, the senate minority leader, the speaker of the house, and the house minority leader each appoint three members.

1991-1992 Committee Members

Senate

Joseph H. Harper, Jr.
Co-chairman
Max S. Case
Judith B. Freedman
Marie A. Herbst
Kevin P. Johnston
Fred H. Lovegrove

House

Robert D. Bowden,
Co-chairman
Brian J. Flaherty
Barbara M. Ireland
Kevin F. Rennie
Carl J. Schiessl
Jessie G. Stratton

Committee Staff

Michael L. Nauer, Ph.D., Director
George W. McKee, Chief Analyst
L. Spencer Cain, Chief Analyst
Carrie E. Vibert, Chief Attorney
Catherine M. Conlin, Principal Analyst
Jill E. Jensen, Principal Analyst
Anne E. McAloon, Principal Analyst
Brian R. Beisel, Associate Analyst
Michelle Castillo, Associate Analyst
Maryellen Duffy, Associate Analyst
Renee La Mark Muir, Associate Analyst
Clifford R. Hamilton, Analyst
Marvin P. Lyon, Analyst
Bonnine T. Klare, Executive Secretary

Staff for this Project

Brian R. Beisel
Michelle Castillo
George W. McKee

DEPARTMENT OF BANKING

LEGISLATIVE PROGRAM REVIEW AND INVESTIGATIONS
COMMITTEE

JANUARY 1993

TABLE OF CONTENTS

EXECUTIVE SUMMARY	i
INTRODUCTION	1
Scope of Review	1
Methodology	1
Report Format Organization	2
Agency Comments	2
I. OVERVIEW OF THE DEPARTMENT OF BANKING	3
Purpose	3
Organization	3
Resources	3
Overview of Regulated Industries	6
II. CHARTERING BANKS AND CREDIT UNIONS	9
State Banks	9
State Credit Unions	13
III. EXAMINATION OF BANKS AND CREDIT UNIONS	19
Bank Examination Process	19
Uniform Bank Rating System	19
Examination Process	22
Enforcement Actions	27
Bank Failures	28
Credit Union Examination Process	29
IV. SECURITIES AND BUSINESS INVESTMENTS DIVISION	33
Securities and Business Opportunity Registration	33
Broker-Dealer and Investment Adviser Registration	35
Examination	36
Enforcement	36
V. CONSUMER CREDIT REGULATION	39
Licensing	39
Enforcement	40
Public Inquiries/Complaints	43

VI.	FINDINGS AND RECOMMENDATIONS	45
	Chartering	45
	Bank Safety and Soundness Regulation	51
	Information Available to Bank Examination Division	51
	Timeliness of Information	54
	Reaction to Information	56
	Sample Analysis of Examinations	58
	Securities and Business Investments	62
	Registration and Examination	62
	Enforcement	64

APPENDIX

A. Agency Response

EXECUTIVE SUMMARY

The Legislative Program Review and Investigations Committee authorized a study of the Department of Banking in March 1992. The purpose of the study was to evaluate the overall management and performance of the department. The study focused on three department functions: 1) the chartering of state banks; 2) the monitoring of state banks for safety and soundness; and 3) the regulation of securities and business opportunities.

The committee concludes that the crisis in the state's banking system, which began in the late 1980s, was primarily caused by an interaction between the severe downturn of the state's economy and the rapid increase in the number of newly chartered banks. Further, the committee concludes that, for the most part, the monitoring system used by the Department of Banking to detect safety and soundness problems within banks works well. It provides appropriate information in a timely manner. However, the department, which had not experienced issues of this magnitude since the 1930s, was slow to respond to the banking crisis initially. Ultimately, the department became more aggressive in using its regulatory powers, although it is debatable whether the department could, or even should, have saved many of the failed banks even if it had acted sooner.

With respect to the other responsibilities of the Department of Banking, the committee finds that insufficient resources are devoted to the department's efforts in securities regulation. The Legislative Program Review and Investigations Committee has adopted the following recommendations aimed at rectifying the problems identified as a result of the study:

- 1. The Department of Banking shall be responsible for obtaining, at the applicant's expense, any feasibility studies and financial forecasts required by the state as part of its chartering process. In no case shall the cost to the applicant, including imposed fees and reimbursable expenses levied by the Department of Banking, exceed \$25,000.**
- 2. The three-member panel shall make written findings of fact on all statutory criteria pertaining to the granting of a state charter.**

3. The commissioner of the Department of Banking shall be authorized to hold public hearings related to the criteria outlined in C.G.S. § 36-52c and make written findings and nonbinding recommendations.
4. The Department of Banking should establish a goal of 30 days to develop final exam reports and transmit these reports to banks. This goal should be met by the end of FY 93 and continually thereafter.
5. Whenever an enforcement action is warranted, it should be prepared and issued to a bank within 60 days after the exam is completed for that bank. For the purposes of establishing the beginning date for the 60-day limit, an exam should be considered completed no later than 90 days after it was begun.
6. The commissioner of the Department of Banking shall be given the authority to make public any cease and desist order he or she issues against a bank, or its individual directors or officers. Such order can only be made public after any person subject to the order has been heard by the commissioner in accordance with Chapter 54 of the Connecticut General Statutes.
7. The commissioner of the Department of Banking shall be given broader authority to remove any bank director or officer of any institution subject to the commissioner's jurisdiction, if such person(s) is found by the commissioner to be negligent in conducting business at the institution where he or she is a director or officer, or any other banking institution. Such action can only occur in accordance with Chapter 54 of the Connecticut General Statutes.

- 8. The commissioner of the Department of Banking shall be given the authority to issue a civil penalty, not exceeding \$10,000 per violation, against any bank director or officer who the commissioner finds has violated any law, regulation, or rule under the commissioner's jurisdiction, or any contract entered into with the commissioner. Prior to such penalty, the commissioner shall hold a hearing upon the charges made, unless such person or persons fail to appear at the hearing. Such hearings shall be held in accordance with the provisions of Chapter 54 of the Connecticut General Statutes.**
- 9. Staff resources assigned to the Securities and Business Investment Division should be increased. In particular, the division should be provided:**

 - more examiners to increase the percentage of registrants periodically examined;**
 - a corresponding increase of legal support staff; and**
 - a person specifically assigned responsibility for developing and administering an education program aimed at registrants and consumers.**

INTRODUCTION

The Department of Banking is responsible for regulating the state's financial institutions to ensure their soundness and protect the public interest. In order to determine whether safety and soundness regulation of Connecticut's state banks is effective, particularly in light of the high number of recent bank failures, the Legislative Program Review and Investigations Committee authorized a study of the state Department of Banking in March 1992.

Scope of Review

The scope of the study focused primarily on the regulatory practices used by the department to ensure the safety and soundness of the state's financial institutions and the protection of the investing public. The study focused on the relationship between state and federal regulatory practices, the process used to charter state banks and credit unions, the process followed in supervising state chartered depository institutions, the department's enforcement of securities and business investment laws and regulations, and the management of the department with respect to policy development, resource allocation, and market analysis.

Methodology

A variety of sources and research methods were used in conducting the study of the department. State statutes, state and federal regulatory reports and documents, and relevant literature were reviewed. Numerous structured interviews were held with department staff, including directors and support staff of each division within the department, to gain an understanding of the department's policies and procedures. Meetings were also held with industry associations. Further, committee staff met with representatives of the Northeast Regional Office of the Federal Deposit Insurance Corporation to discuss its role and relationship as it relates to the regulation of state banks in Connecticut. Staff also attended a conference on securities regulation sponsored by the banking department.

In addition to the methods just mentioned, a sample of 80 bank examinations completed by both state and federal examiners was analyzed. The sample included exams of 10 banks remaining open between 1987 and 1992, and of 10 banks failing during this period. The examinations were reviewed to determine whether the department has information it needs to properly regulate banks, if the information is collected on a timely basis, what is done with the information after it is collected, and if the department reacts to the information in a timely manner. In addition to bank examinations, the files of 15 of the 27 applications for bank charters filed with the banking department between 1985 and 1989 were reviewed. The files were analyzed to determine the time required to complete key phases of the application review process, gather information concerning the backgrounds of the proposed organizers, review the quality of the information supporting the applications, and assess the thoroughness of the review by the bank charter approval panel and the banking department staff.

In the area of securities regulation, a sample of 37 examinations and 255 investigations was reviewed. The sample was analyzed to determine timeframes and resources used in completing securities examinations and investigations. The files were also examined to determine final disposition of cases.

Report Format Organization

The report contains descriptive information and analysis of the department's major functions related to chartering and monitoring state banks and credit unions and regulation of securities and business opportunities. A description of the department's regulation of consumer credit is also included; however, no findings or recommendations are made in this area. The report is organized into six chapters. Chapter I provides an overview of the department's administrative structure and resources. Chapter II details the chartering process related to state banks and credit unions. Chapter III is a description of the department's regulation of state banks and credit unions. Chapter IV describes the department's processes and procedures relating to securities and business opportunities. Chapter V provides background information on the regulation of consumer credit. Finally, Chapter VI provides detailed analysis of the department's performance, and findings and recommendations made by the committee.

Agency Comments

It is the policy of the Legislative Program Review and Investigations Committee to provide state agencies subject to a study with an opportunity to review and comment on the recommendations prior to the publication of the final report. The response from the commissioner of the Department of Banking is contained in Appendix A.

CHAPTER I

OVERVIEW OF THE DEPARTMENT OF BANKING

Purpose

The purpose of the Department of Banking is to insure the safety and soundness of the state's financial institutions and protect the public interest. In this capacity, the department functions as a regulatory agency overseeing financial institutions that are chartered, licensed, or registered by the state. It also operates as an enforcement agency, monitoring compliance with state laws pertaining to securities, tender offers, and business opportunities.

Organization

Figure I-1 depicts the department's organizational structure, which is composed of a commissioner's office and four divisions. The commissioner's office consists of the commissioner, deputy commissioner, and their clerical assistants. The four divisions are organized around the specific functions implied by their names: (1) Administration; (2) Depository Institution Regulation; (3) Securities and Business Investments; and (4) Consumer Credit.

The Administrative Division is a collection of five autonomous units including affirmative action, business and personnel, legal services, management information, government relations, and public information. There is no overall division director; each unit reports directly to the commissioner's office.

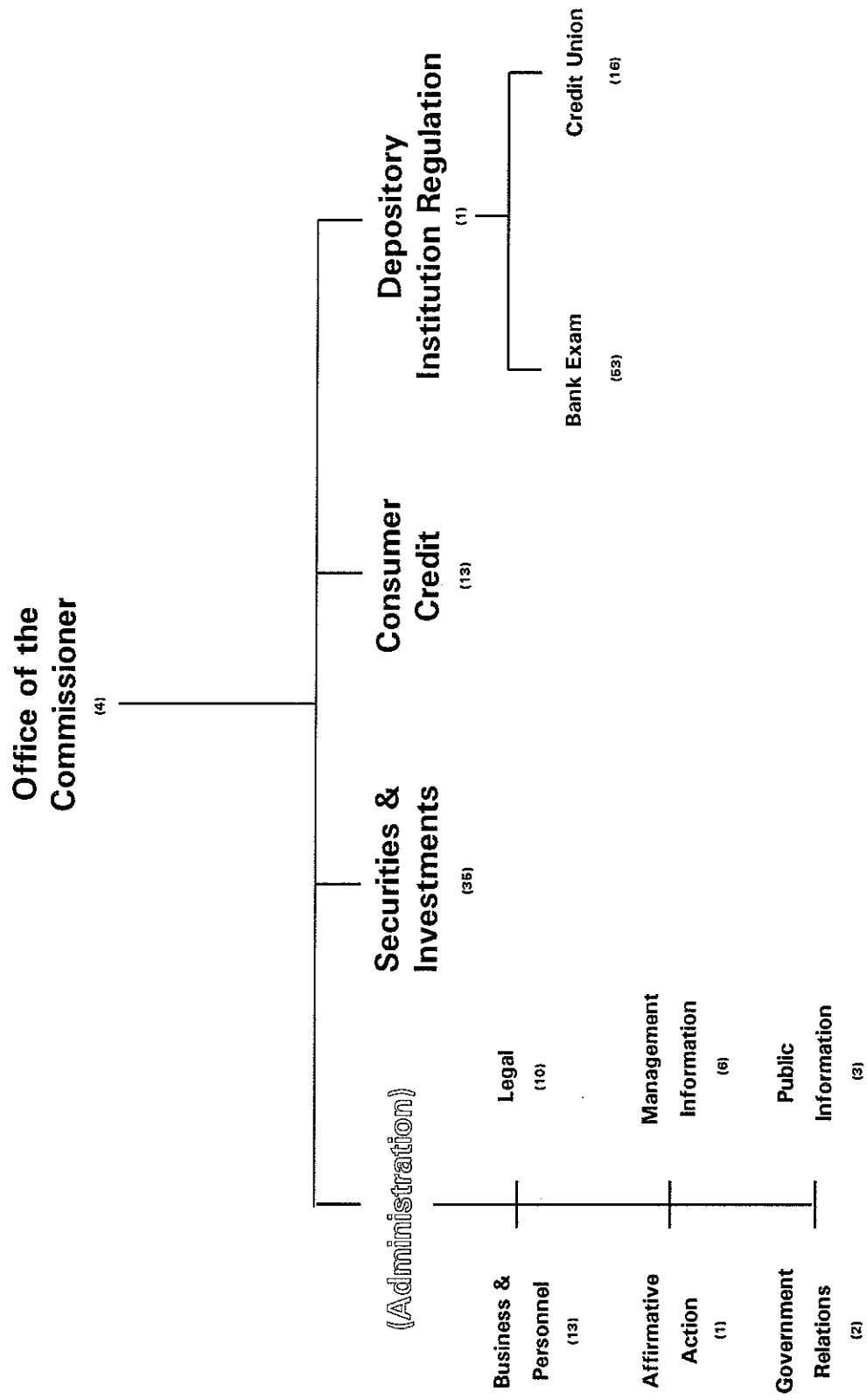
The Depository Institution Regulation Division is split into two units, one regulating state chartered banks and the other regulating state chartered credit unions. Each unit has its own director who reports to the division's head.

The Securities and Business Investments Division is subdivided in four sections including: (1) security and business opportunity registration; (2) broker-dealer and investment advisor registration; (3) examination; and (4) enforcement. The head of each section is under the supervision of one of two assistant directors, both of whom report to the division director.

Resources

The Department of Banking was appropriated approximately \$12.4 million both in FY 92 and FY 93. Figure I-2 shows the department's actual and inflation-adjusted expenditures for state fiscal years 1987 through 1992. Note that on an inflation adjusted basis, there is only a slight upward trend in expenditures over the period. The department's filled staff positions also exhibited a remarkable stability during the period, ranging from a 140 to 145 and averaging 143.

FIGURE I-1. DEPARTMENT OF BANKING



All expenditures of the Department of Banking are paid out of a dedicated fund, known as the Banking Fund. The fund is financed by assessments and fees levied against institutions and individuals licensed and regulated by the department. Beginning with FY 91, expenditures from the fund can only be made pursuant to appropriations by the General Assembly (Public Act 91-14 June Special Session).

FIGURE I-2. EXPENDITURES BY THE DEPARTMENT OF BANKING (FY 87-FY 92)

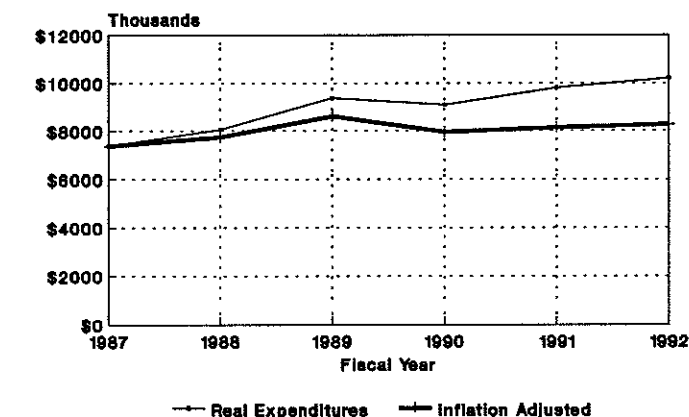


Figure I-3 compares the source of money supplied to the Banking Fund with its uses averaged over the five fiscal years ending with FY 91. On the revenue side, funds are classified as coming from one of three sources: 1) assessments on banks and credit unions; 2) fees and penalties collected from firms and individuals engaged in activities overseen by the securities division; and 3) license and examination fees paid by firms that are primarily overseen by the Consumer Credit Division. The figure does not include revenues received from miscellaneous sources such as sales of reports or refunds for jury service by employees. Revenues from miscellaneous sources are insignificant, averaging less than one-half of one percent of all revenues.

License and examination fee schedules are set in statute. The assessment on banks and credit unions is based on a formula, which is recalculated every six months. The assessment must approximate the difference between the department's forecasted expenditures for the coming six-month period and the fees it expects to collect, plus the estimated cash balance at the beginning of the period. Using the estimates, a rate is calculated that, when multiplied by the assets held by all state banks and credit unions, will raise the funds needed. The assessment paid by an individual bank or credit union is that rate times the assets held by the institution.

The use of funds graph pictured in Figure I-3 was constructed using expenditure data from FY 87 through FY 91. It should be noted that the administrative category includes expenses attributed to the commissioner's office, and that none of the administrative expenses have been distributed among the other divisions.

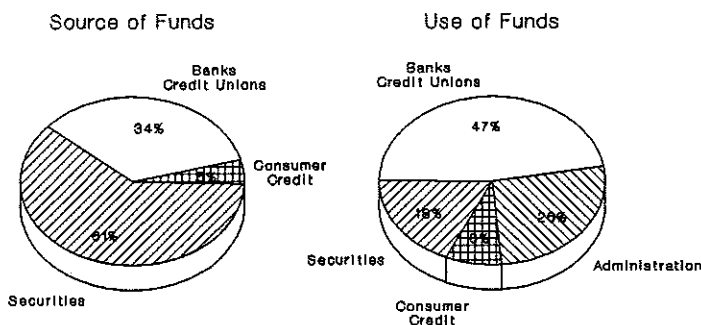
Figure I-3 shows a significant imbalance between the source and use of funds. For example, firms and individuals engaged in securities activities accounted for about 61 percent of the department's revenues, but expenses related to their regulation consumed less than 20 percent of the department's total. While the imbalance would probably be reduced if the administrative expenses, particularly those of the legal unit, were allocated among the depar-

tment's activities, it would not be eliminated.

FIGURE I-3. SOURCE AND USE OF FUNDS BY THE DEPARTMENT OF BANKING

Overview of Regulated Industries

Banking. Connecticut, like the rest of the nation, operates under a dual banking system. This system of chartering and supervising financial institutions has existed since 1864. Prior to this date, only states granted charters and regulated these institutions. However, with the passage of the National Currency Act in 1864, the federal government granted itself the power to create a national currency and to charter national banks. Since that time, banks chartered and supervised by either the federal government or state governments have co-existed.



Source of Data: Department of Banking
Financial Reports (FY 87-FY 91)

Under the dual system, different governmental agencies are responsible for regulating and supervising the industry. The type of financial institution, and whether it is state or federally chartered, determines the involvement of a particular regulator. At the federal level, the following agencies are responsible for regulating financial institutions:

1) **The Federal Reserve System**, known as the "Fed", is responsible for setting national monetary policy and regulating banks that are members of the reserve system. National banks must be members of the system; state chartered banks have the option of being members. The "Fed" also regulates bank holding companies. Presently, there are no state chartered banks in Connecticut belonging to the Federal Reserve System.

2) **The Office of the Comptroller of the Currency**, located within the Treasury Department, was established in 1863 as the first federal agency to regulate financial institutions. It is responsible for chartering, examining, and supervising national banks.

3) **The Office of Thrift Supervision** is a newly-formed division of the Treasury Department responsible for chartering federal thrifts and supervising state thrifts and thrift holding companies. The office is a direct result of the Financial Institutions Reform, Recovery, and Enforcement Act passed by Congress in 1989, which eliminated the Federal Home Loan Bank Board and transferred its responsibilities to the Office of Thrift Supervision.

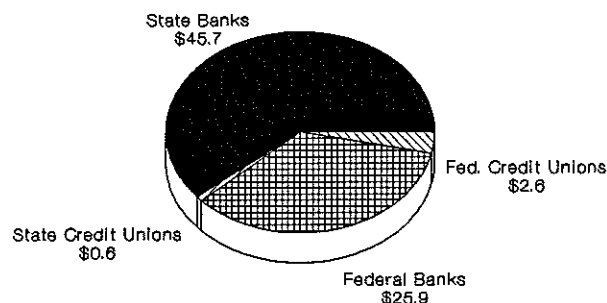
4) **The Federal Deposit Insurance Corporation (FDIC)** is an independent agency of the federal government created in 1933. The corporation is responsible for providing federal insurance for bank deposits up to a \$100,000 limit for each depositor. The agency also acts as the primary federal regulator of mutual savings banks and banks that hold state charters and are not members of the Federal Reserve System.

5) **The National Credit Union Administration (NCUA)** is an independent governmental agency created in 1970. NCUA is mainly responsible for chartering, supervising, and examining federal credit unions. Under certain circumstances, NCUA will examine state chartered credit unions. NCUA also administers the National Credit Union Share Insurance Fund, which insures individual depositor accounts up to \$100,000.

As of December 31, 1991, Connecticut had 104 state chartered banks and 86 state chartered credit unions. There were an additional 30 banks and 187 credit unions operating under federal charters. Combined, the state chartered institutions were much larger, totalling \$46.3 billion in assets and \$39.6 billion in deposits, compared with \$28.5 billion in assets and \$24.2 billion in deposits for federally chartered institutions.

Figure I-4 depicts the distribution of assets by type of institution and chartering authority. The figure shows that state banks, as a group, account for the largest share of assets (61 percent). Federal banks, which hold 35 percent of all assets, are next in size, followed by federal credit unions (3 percent) and state credit unions (1 percent). It should be noted that slightly over 80 percent of the federal bank assets are held by just three banks.

FIGURE I-4. DISTRIBUTION OF ASSETS
(in billions)



Source of Data: Dept. Of Banking

The 104 state banks included 41 bank and trust companies, 57 savings banks, and 6 savings and loan associations. At one time these distinctions were important because the type of charter a bank held dictated the activities it could undertake. For example, institutions chartered as savings banks were prohibited from engaging in commercial lending. However, in recent years, as the differences between the powers granted under the charters have been virtually eliminated, the distinction has become nearly meaningless.

Securities and business opportunities. As of June 30, 1992, Connecticut had 1,505 broker-dealer and 757 investment adviser firms. The firms employed 53,312 registered broker-dealers and 5,274 investment adviser agents. During this same time period, the department received 2,568 securities and 58 business opportunities registration filings to be offered and sold in Connecticut.

CHAPTER II

CHARTERING BANKS AND CREDIT UNIONS

State Banks

State bank charters are granted by a majority vote of a panel consisting of the State Banking Commissioner, Comptroller, and Treasurer. The process leading to the panel's vote is overseen by the banking department and is governed by state statutes and department policies.

Staff work related to the panel's responsibilities is primarily carried out by the department's Depository Institution Regulation Division. Personnel from this division guide applicants through the process, verify that all requirements have been met, obtain independent information needed to evaluate the application, and discuss their findings with the commissioner.

While the requirements may vary depending on the type of charter sought, the basic procedure follows the outline shown in Figure II-1. For analytical purposes, the process can be divided into three phases. The first phase pertains to the work associated with developing the application, and is essentially carried out by the applicants and their financial and legal advisors. The department's role during this phase is limited to providing information to potential bank organizers and guidance on what is required.

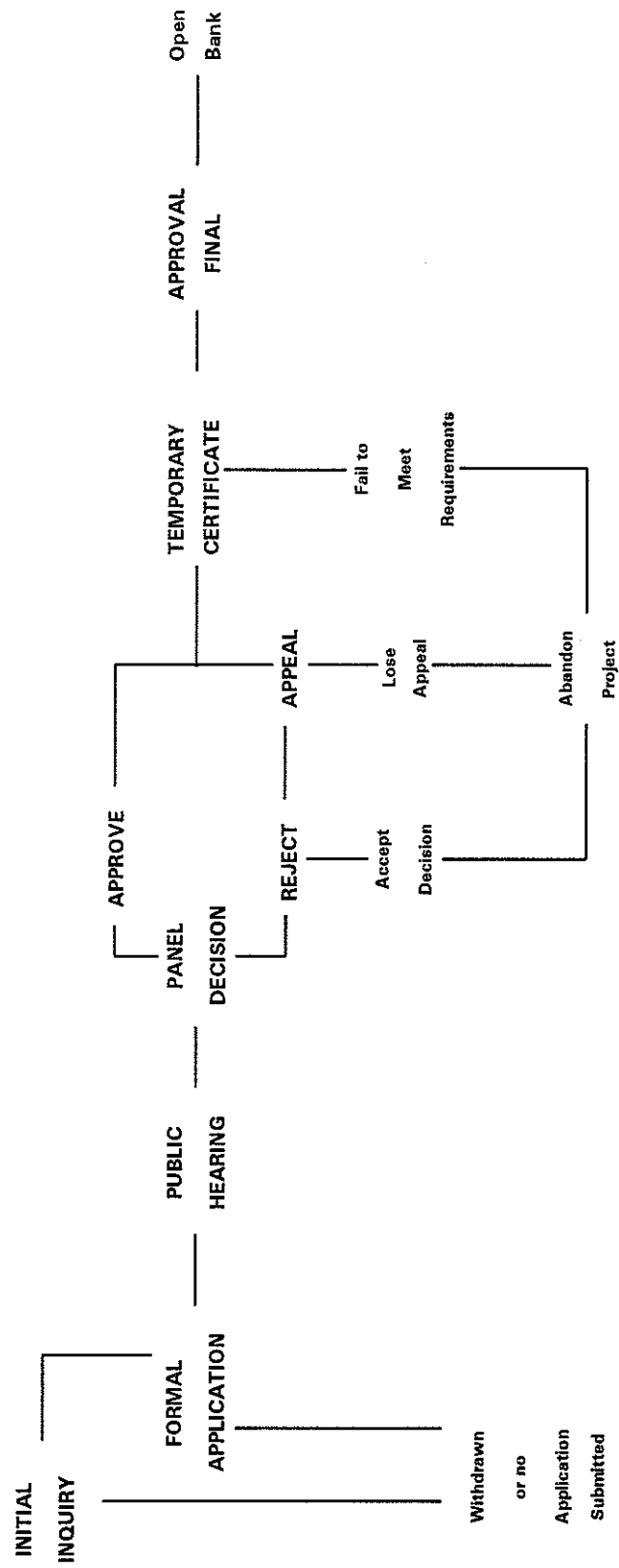
The second phase covers the formal review of the application. The banking department plays a very active role in this phase. It is involved in everything from assuring the application is complete to obtaining background information from independent sources. The review phase ends with the panel's initial decision and any related appeals.

The final phase occurs only if the panel has given the applicants a temporary certificate of authority. This certificate gives the organizers an opportunity to complete the bank's incorporation and meet all remaining state and federal banking requirements. The department's role is limited to verifying compliance. The department's final activity before the bank can open is to perform an on-site inspection to insure that all state requirements governing a banking facility are met.

Phase One: Initial exploration. The chartering process begins when individuals with an interest in obtaining a state bank charter contact the banking department. The potential bank organizers are informed that a minimum of \$5 million in capital is needed to start a state chartered bank and a \$10,000 filing fee must accompany the official application. Additional requirements are outlined by the staff and enumerated in the official application form. Among these requirements are:

- completion of a feasibility study detailing the economic characteristics of the area to be served;

FIGURE II-1. STATE BANK CHARTERING PROCESS



- development of a business plan and financial forecast;
- submission of detailed financial and biographical information on the bank's proposed officers and directors;
- identification of existing banks and financial entities servicing the area;
- description and cost estimates of all facilities and related furnishings and equipment; and
- identification of the amounts and recipients of all fees and expenses associated with the application.

Applicants are also made aware that the proposed bank must maintain a minimum capital to total assets ratio of eight percent during its first three years of operation and secure deposit insurance from the Federal Deposit Insurance Corporation (FDIC).

Phase Two: Review. The second stage commences when the required documents begin to be submitted. The documents are reviewed first for completeness and then for content by staff from the department's Depository Institution Regulation Division. Of primary concern with respect to content are: the adequacy of the proposed bank's capital base; the thoroughness and outcome of the organizer's feasibility study and financial forecast; the convenience of the public; and the financial viability, experience, and character of the bank's proposed executive officers and directors.

In evaluating the application, the staff consult economic and demographic data for the area to be served by the proposed bank, as well as performance data on banks already servicing the area. In addition, credit checks and law enforcement background checks are obtained on all the bank's proposed executive officers and directors.

Toward the end of this stage, the staff meet with the applicants and their advisors to informally discuss the application and resolve any outstanding issues. Also, the staff inform the FDIC of the pending application.

Once all of the required documents have been obtained, a public hearing on the application is scheduled. State law requires the banking commissioner to set the hearing date between 30 and 60 days after receipt of a completed application. Copies of the documents are forwarded without comment to the State Comptroller and Treasurer and are made available for inspection by the public.

Prior to the hearing, the commissioner meets with the director and other staff of the banking regulation division to review informally the application. The department staff are also

available to answer any questions the State Comptroller and Treasurer may have on the application.

The commissioner chairs the hearing, which is fully transcribed and typically lasts about two hours. During the hearing, the organizers and their advisors review details of the application and answer questions from the panel members. Citizens and representatives of other banks can attend and testify. The panel's decision may be made immediately or it may take up to 30 days. The length of time is dependent on the complexity of the application and the issues involved.

Various sections of the state's general statutes describe criteria to be considered by the panel in making its decision. The criteria, although somewhat vague and overlapping, can be summarized as follows:

- population of the area to be served;
- adequacy of the existing facilities servicing the area;
- character and experience of the proposed officers and directors;
- convenience and necessity of the bank to the public;
- economic need for the bank; and
- reasonableness of the bank's chance to succeed.

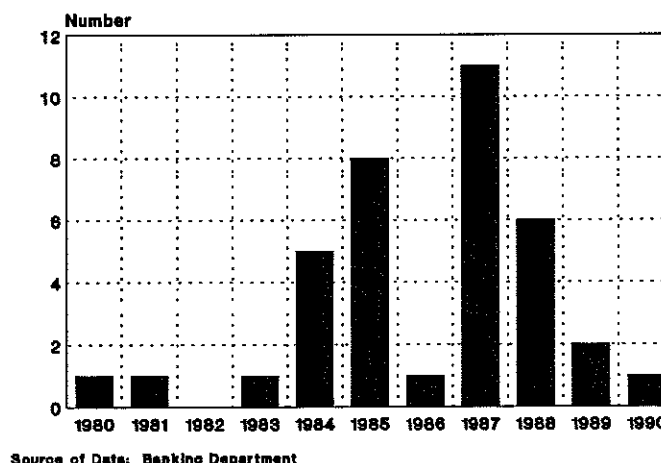
Any decision of the panel can be appealed in accordance with the provisions of the state's Uniform Administrative Procedure Act (Chapter 54 of the Connecticut General Statutes).

Phase Three: Final approval. If the panel approves the application, a temporary certificate of authority is issued. The temporary certificate authorizes the organizers to take up to 18 months to become fully incorporated, raise the necessary capital, and obtain federal deposit insurance. A final certificate of authorization is issued by the panel upon verification that the organizers have complied with the state's corporation laws, paid a franchise tax of 1 cent per share of authorized capital stock, paid a filing fee of \$20, filed with the Secretary of the State a certified list of shareholders showing the number of shares owned, and obtained deposit insurance from the FDIC.

Figure II-2 shows the number of state bank charters issued annually between 1980 and 1990. The graph demonstrates that the issuance of new state charters accelerated from a modest start in 1980 to a peak of 11 in 1987, and then began a steady decline.

An analysis of the data in the Annual Report of the Banking Commissioner for 1990, indicates the 1980s were not a typical decade with respect to issuing state charters. In fact, of the 121 state banks in existence on December 31, 1990, nearly one-third (37) were chartered in the 1980s. The only other decade in the twentieth century exhibiting a similar level of activity was the 1920s, when the state issued 44 new charters.

FIGURE II-2. CURRENT STATUS OF STATE BANKS CHARTERED BETWEEN 1980 and 1990



Two reasons are commonly cited to explain the large number of state charters issued during the 1980s. The first centers on the idea that the rapid growth of the state's economy increased demand for bank services beyond that which could be met by existing banks. This argument focuses on the notion that many existing banks turned away from serving small communities in search of larger, more lucrative, markets elsewhere.

Speculation is the second factor often referenced as a reason for the increase in demand for state charters. This explanation holds that at least some organizers were gambling that the bank they were proposing might at some point become an acquisition target for a larger, in-state bank seeking to expand, or an out-of-state bank if full interstate banking was approved.

State Credit Unions

In addition to bank charters, the Department of Banking also charters credit unions. A credit union is a non-profit financial institution that provides an opportunity for its members to save, borrow, and obtain related financial services. A credit union differs from other depository institutions in that a credit union's membership is united through a common bond of occupation or association.

Requirements. Unlike bank charters, there are no minimum capital requirements for credit union charters. However, state chartered credit unions are required to obtain federal insurance on their share deposits equal to one percent of total insurable shares. This deposit insurance is recorded as an asset on the books of the credit union.

All credit unions operating in Connecticut are insured by the National Credit Union Administration (NCUA). NCUA is the insurance provider for all federal and state chartered

credit unions. The insurance is provided by the National Credit Union Share Insurance Fund, a branch of NCUA.

Application process. Unlike bank charters, which are granted by a majority vote of a three member panel, the banking commissioner is the final decision-maker for issuing credit union charters. The key steps in the chartering process are outlined in Figure II-3.

Any group of seven or more individuals, 18 years or older, may apply for a credit union charter. On average, the department receives one inquiry a week regarding credit union charters. These inquiries are usually in the form of a phone call or a letter and are handled by the credit union unit within the department. During this initial inquiry, the unit director discerns whether the interested group possesses a recognizable and appropriate common bond and should apply for a new credit union charter, or whether the group would be better served incorporating itself with an existing credit union. If the situation is the former, the unit director mails a letter acknowledging the inquiry and includes a package of materials to begin the chartering process.

As noted in Figure II-3, there are preliminary steps that are required before a formal application is submitted. One of the first steps is to conduct a survey of the proposed membership. The department requires applicants to survey their potential membership to determine the level of need and support for the application.

To qualify for a new credit union charter, there must be a potential membership of at least 500. To assist the applicant with this requirement, the department provides a sample format, included in the package of information, that the group should emulate in conducting its membership survey. The survey responses are forwarded to, and reviewed by, the Credit Union Division.

In addition to the survey, applicants must also submit the names of the individuals recruited to sit on the proposed credit union's board of directors. All individuals serving on a credit union's board of directors must be volunteers. Both the applicants and the proposed board of directors must undergo state police background and credit checks.

To ensure the proposed credit union has adequate support and resources, the department recommends that the interested group obtain a sponsor. Usually, a sponsor provides resources and support such as office space and equipment. However, a sponsor incurs no legal liabilities on behalf of the credit union. A sponsor is typically the group's employer, for example, Hartford Hospital. The names of any sponsors must also be submitted to the department as part of the credit union files.

After these pre-application steps are completed, a formal application is submitted. Along with the application, applicants must submit notarized copies of a certificate of organization and copies of the proposed by-laws of the credit union. By statute, the certificate of organization must include:

- the proposed name including "credit union" or "mutual benefit association";
- a statement that the proposed credit union will be perpetual;
- the location of the principal office and any subsidiary;
- a description of the membership in detail;
- any management policies; and
- a statement of the par value of shares.

The proposed by-laws must include:

- the purpose for and the manner by which special meetings will be held;
- the titles and duties of the officers;
- the manner in which officers and directors shall be removed and vacancies filled;
- the length of terms for the officers, supervisory committee, credit committee, and directors; and
- any other provisions for regulation and management.

As Figure II-3 indicates, once the information is filed with the department, the unit director reviews the application, makes a recommendation, and sends copies of the information to NCUA. As mentioned previously, all credit unions are required to secure federal deposit insurance. Applications for deposit insurance are submitted to NCUA through the credit union unit. On average, deposit insurance approval takes approximately 30 days.

After the unit director reviews the application package, he or she forwards a recommendation to the commissioner. Within 30 days from the filing of the certificate of organization and the by-laws, the commissioner is required to render a written decision. In making the determination, the commissioner must consider: 1) if the proposed field of membership is favorable to the success of the credit union; 2) if the certificate of organization and the proposed by-laws meet the statutory requirements; and 3) the character of the incorporators.

If the commissioner deems the application satisfactory, he or she endorses the certificate of organization and proposed by-laws. The department retains one copy of the certificate of organization and by-laws and files one copy of each with the Secretary of the State. The applicant also receives a copy of the certificate of organization certified by the Secretary of the State. Finally, the applicants must hold an organizational meeting to elect directors, adopt the by-laws, and conduct any other business to complete the organization of the credit union.

Figure II-3. Key Steps in Credit Union Chartering Process.

Step 1. Initial Inquiry

- A. Division receives phone or mail inquiry regarding credit union charter.
- B. Division director advises group:
 - a. Merge with existing credit union
 - b. New charter
 - c. No action
- C. Department mails package of information.

Step 2. Pre-application Steps (Applicant)

- A. Applicant conducts survey of potential membership.
- B. Applicant recruits volunteers to act as board of directors.
- C. Applicant seeks sponsor.
- D. Applicant submits to department:
 - a. Survey results
 - b. Names of proposed board of directors
 - c. Name of sponsor

Step 3. Pre-application Steps (Department)

- A. Division staff reviews survey results.
- B. Division staff conduct police and credit check on applicants and proposed board of directors.

Step 4. Formal Application

- A. Applicant submits to the department:
 - a. formal charter application
 - b. certificate of organization
 - c. proposed by-laws
 - d. deposit insurance application
- B. Division director:
 - a. reviews application package
 - b. makes a recommendation
 - c. forwards copies of application package to NCUA
- C. Commissioner reviews application and recommendation and renders written decision.

Step 5. Credit Union Holds Organizational Meeting

Charter activities. Although the department receives many inquiries regarding credit union charters, the number actually completing the chartering process is quite low. Currently, there is one new charter application pending approval. The last credit union to be chartered by the state was in 1988.

CHAPTER III

EXAMINATION OF BANKS AND CREDIT UNIONS

The Department of Banking is responsible for conducting safety and soundness examinations of state banks and credit unions through its Bank Examination and Credit Union Divisions. These exams, required by state law to be done as frequently as the commissioner requires, are designed to help ensure the viability of banks and credit unions and protect consumers who use their services. The Bank Examination Division is also responsible for other functions such as licensing check cashiers and money forwarders, administering compliance reviews pertaining to the state's Community Reinvestment Act, and performing exams of trust departments.

Only state chartered financial institutions are examined for safety and soundness by the banking department. Examinations of federally chartered banks are the responsibility of either the Federal Reserve, the Office of the Comptroller of the Currency (OCC), or the Office of Thrift Supervision (OTS). Federal credit unions are examined by the National Credit Union Administration (NCUA). In addition, since all banks in Connecticut are required to have federal deposit insurance, they are also subject to examination by the Federal Deposit Insurance Corporation (FDIC). The FDIC conducts bank exams to safeguard its insurance fund.

The following chapter describes the examination processes for both state chartered banks and credit unions.

BANK EXAMINATION PROCESS

Uniform Bank Rating System

The FDIC uses a uniform, although subjective, rating system for examinations of all financial institutions. The system is used by both state and federal regulators whenever exams are conducted. (The information for the following description of the uniform rating system is from the FDIC's Manual of Examination Policies).

The examination manual states that upon the recommendation of the Federal Financial Institutions Examination Council, the Corporation's Board of Directors adopted a policy statement in November 1979 entitled "Uniform Financial Institutions Rating System" (UFIRS). This statement was similarly adopted by other federal regulators including the National Credit Union Administration, Federal Home Loan Bank Board, Board of Governors of the Federal Reserve System, and Office of the Comptroller of the Currency. The rating system reflects an institution's financial condition, compliance with laws and regulations, and overall operating soundness. Its primary purpose is to help identify those institutions whose weaknesses in these three areas require special supervisory attention and/or warrant a higher than normal degree of concern.

Composite ratings. In accordance with UFIRS, each bank is assigned a composite rating based on an evaluation of pertinent financial and operational standards, criteria, and principles. This overall rating is expressed through use of a numerical scale ranging from "1" to "5" in ascending order of supervisory concern; "1" indicates the highest rating and least degree of supervisory concern, while "5" is the lowest rating and therefore the highest degree of concern. Composite ratings as defined in the FDIC's policy manual are distinguished as follows:

Composite "1" -- Institutions in this group are basically sound in every respect; any adverse findings or comments are of a minor nature and can be handled in a routine manner. As a result, such institutions give no cause for supervisory concern.

Composite "2" -- Institutions in this group are fundamentally sound, but may reflect modest weaknesses correctable in the normal course of business. While areas of weakness could develop into conditions of greater concern, the supervisory response is limited to the extent that minor adjustments are resolved in the normal course of business and that operations continue satisfactorily.

Composite "3" -- Institutions in this category exhibit financial, operational, or compliance weaknesses ranging from moderately severe to unsatisfactory. When weaknesses relate to financial condition, such institutions may be vulnerable to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Overall strength and financial capacity, however, are still such as to make failure only a remote possibility.

Composite "4" -- Institutions in this group have serious financial weaknesses. Unless effective action is taken to correct these conditions, they could reasonably develop into a situation that could impair future viability, constitute a threat to the interests of depositors, and/or pose a potential for disbursement of funds by the insuring agency. Institutions in this category require close supervisory attention and financial surveillance and a definitive plan for corrective action.

Composite "5" -- This category is reserved for institutions with an extremely high immediate or near term probability of failure. The volume and severity of weaknesses or unsafe and unsound conditions are so critical as to require urgent aid from stockholders or other public or private sources of financial assistance.

Assessment of certain performance components, and their interrelationships, represents the essential foundations upon which composite ratings are based. The important point is that the principal purpose of UFIRS is to identify, via the composite rating, those institutions which merit special supervisory attention and/or warrant a higher than normal degree of supervisory concern.

Performance evaluation components. To aid in implementing the rating system, the FDIC uses a similar scale of one to five to assess five key performance components on which the overall composite rating is principally based. These performance components are commonly identified by the acronym "CAMEL", which stands for: Capital adequacy; Asset quality; Management; Earnings; and Liquidity. The following is a discussion of the guidelines and standards to be applied when assigning performance ratings and the composite rating.

Capital Adequacy -- Rated in relation to: the volume of risk assets; the volume of marginal and inferior quality assets; bank growth experience, plans, and prospects; and the strength of management. Consideration should also be given to a bank's capital ratios relative to its peer group, its earnings retention, and its access to capital markets or other appropriate sources of financial assistance.

Asset Quality -- Rated in relation to: the level, distribution, and severity of classified assets; the level and distribution of nonaccrual and reduced rate assets; the adequacy of valuation reserves; and management's demonstrated ability to administer and collect problem credits. Asset quality evaluation should also take into consideration any undue degree of concentration of credits or investments, the nature and volume of special mention classifications, and the adequacy of lending policies and credit administration procedures.

Management -- Evaluated against virtually all factors considered necessary to operate the bank within accepted banking practices and in a safe and sound manner. Thus, management is rated in relation to: technical competence, leadership, and administrative ability; ability to plan and respond to changing circumstances; adequacy of and compliance with internal policies; and depth and succession. The assessment of management also takes into account the quality of internal controls, operating procedures, and all lending, investment, and operating policies and the involvement of the directors and shareholders.

Earnings -- Rated with respect to: the ability to cover losses and provide for adequate capital; earnings trends; peer group comparisons; the quality and composition of net income; and the degree of reliance on interest-sensitive funds. Consideration should also be given to the interrelationships between the dividend payout ratio, rate of growth of retained earnings, and adequacy of bank capital. The adequacy of transfers to the valuation reserve, and the extent to which extraordinary items, securities transactions, and tax effects contribute to net income, should also be assessed.

Liquidity -- Rated in relation to: the volatility of deposits; the frequency and level of borrowing; technical competence relative to structure of liabilities; availability of assets readily convertible into cash; and access to money markets or other ready sources of funds. The bank's liquidity position should be appraised over a period of time as well as on a particular date. The nature, volume, and anticipated usage of credit commitments are also factors to be weighed.

The ratings below measure the five crucial performance components used in determining composite scores for financial institutions.

Rating "1": Indicates strong performance, significantly higher than average.

Rating "2": Reflects satisfactory performance, performance which is average or above; this includes performance that adequately provides for the safe and sound operation of the bank.

Rating "3": Represents performance that is flawed to some degree and as such is considered fair. It is neither satisfactory nor unsatisfactory but is characterized by performance that is or below average quality.

Rating "4": Refers to marginal performance, significantly below average. If left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.

Rating "5": Considered unsatisfactory; performance that is critically deficient and in need of immediate remedial attention. Such performance, by itself or in combination with other weaknesses, threatens the viability of the institution.

Examination Process

Besides the different factors analyzed during exams, and the system used to rate these factors, there are several key steps in the bank examination process. These steps are described below and outlined in Figure III-1.

Choosing banks for examination. Until June 1992, safety and soundness exams of financial institutions were performed independently by either the state or the FDIC, or jointly between the two. However, the banking department and the FDIC have since agreed to eliminate joint exams--although exams may still be conducted concurrently resulting in separate reports. From now on, an examination schedule alternating between state and federal regulators will occur. This is being done to alleviate logistical problems associated with having financial institutions examined simultaneously, as well as to increase exam efficiency.

Currently, the Bank Exam Division and the FDIC meet on a semi-annual basis to schedule on-site examinations. When scheduling exams, various methods are used to help the regulators determine which banks should be examined. For example, the division and the FDIC have the ability to analyze banks' performance on a quarterly basis. Using this information, decisions can then be made whether to conduct a full examination of a particular bank. Exams may also be scheduled if a bank has not been examined by either the division or the FDIC within a certain time period.

Figure III-1. Key Steps in Bank Examination Process.

Step 1. Choosing Banks for Examination

- A. Bank Exam Division and FDIC jointly choose banks
- B. Exam schedule developed
- C. Decision made as to which regulator will examine state chartered banks

Step 2. Assigning Examiners for Exams Conducted by Banking Department

- A. Examiner-in-Charge chosen
- B. Field examiners selected

Step 3. Preliminary Exam Preparation

- A. Selected documents reviewed prior to exam

Step 4. Notification of Pending Exam Sent to Bank

- A. Reasons for prenotification of bank
- B. Reasons when bank not prenotified

Step 5. Actual Examination Conducted

- A. Full exam
- B. Modified exam
- C. Exam components reviewed and rated
- D. Preliminary meeting with bank directorate

Step 6. Final Report Developed

- A. Examiner-in-charge submits final exam report for review
 - B. Exit meeting held with bank's board of directors
 - C. Information sent to FDIC
-

One of the methods used by the Bank Exam Division to monitor and analyze a bank's performance is through reports submitted by banks to the division. One specific report is a "call report", submitted quarterly, which is an extended balance sheet and income statement showing a bank's assets and liabilities. This report gives the division the ability to frequently track a bank's performance without having to conduct a detailed examination of the bank. It also helps the division to isolate particular problems a bank may be experiencing, usually resulting in an exam being scheduled.

As for the frequency of exams, prior to 1989, the Bank Exam Division conducted on-site evaluations of all state banks on an annual basis. However, the committee has been informed that due to ensuing problems within the state's banking industry, examinations have become more involved and time consuming. As a result, the division has lengthened the cycle for examining each state bank to approximately 18 months.

Although the exam division has lengthened its exam cycle to 18 months, current FDIC guidelines state that banks with composite CAMEL ratings of "4" or "5" be examined yearly by federal regulators. Institutions with composite ratings of "3", and determined to have overall unstable conditions, are also to be examined at yearly intervals. Those institutions rated either "1", "2", or "stable 3", are to be examined approximately every 18 months, under FDIC guidelines.

Choosing examiners. At present, the Bank Examination Division has six managers and 43 field examiners. Included in the number of field examiners are five examiners assigned to the office to handle various in-house responsibilities.

Although the actual number of examiners needed to conduct an exam depends on the size and complexity of the institution being examined, the department tries to use an average of five to seven examiners for each exam. One of these examiners is designated Examiner-in-Charge. This person is responsible for: 1) overall management of the exam and deciding work assignments for the other examiners; 2) administrative responsibilities; and 3) final decisions regarding the individual component and composite CAMEL ratings at the completion of the examination. A chief examiner or a supervisory examiner may also be assigned to the exam team, but only if the division director deems it necessary--usually for very complex examinations.

A supervisory examiner within the division is currently responsible for assigning examiners to different specific exams and other special projects. Assignments are made mainly on examiners' availability at the time of the exam and also on their areas and levels of expertise. Although examiners receive training in all aspects of conducting exams, each may have his or her own level of experience in the various components comprising bank exams. It is up to the supervisory examiner to take these different variables into consideration and make assignments accordingly.

Preparation for exams. Preliminary work is done to help examiners prepare for an exam. Examiners usually review call reports submitted to the department by the bank over the previous two years, with emphasis on the latest report, to gain an understanding of the bank and potential problem areas. Examiners also analyze the latest two exams conducted for the bank under review, as well as evaluate how well the bank has complied with previous recommendations made by regulators.

All of this information is assembled for field examiners conducting the actual exam by the other examiners assigned to the office. Once the information is compiled, it is reviewed by the division director before actually being distributed to the examiners.

Exam notification. After the determination is made that examinations will be conducted, the exam division may or may not pre-notify banks of the pending exams. Certain circumstances under which the Bank Exam Division will not pre-notify banks include special investigations, public complaints about a specific bank practice, exams relating to special conditions such as a bank's policy and performance concerning reinvestment in surrounding communities, and modified exams of banks with composite ratings of either "4" or "5".

When the division decides to pre-notify a bank of an exam, it attempts to send a "first day notice" at least 30 days prior to when the exam is scheduled to begin. This notice informs bank officials of the date when the exam will begin and what information is to be made available to the examiners at that time. Pre-notifying a bank of an exam allows the bank to gather necessary records and files so that time is not wasted doing this after the exam begins.

Actual exam. The actual examination of a financial institution covers several main areas. As previously mentioned, the examiners are primarily interested in analyzing a bank's capital adequacy, asset quality, management, earnings, and liquidity -- CAMEL elements. Examiners are also concerned with how well a bank is following particular requirements specified by law or regulation, such as community reinvestment, as well as its compliance with, and implementation of, recommendations made in previous exams. The division said that the average time for completing an exam currently ranges from five to six weeks. Complex exams may run longer.

Prior to completion of an exam, examiners and bank management may discuss the bank's loan portfolio, but not the specific CAMEL or composite ratings. At these meetings, loans perceived by examiners to have more than normal risk, or a record of questionable performance, are discussed with the bank officials. In addition, examiners also tell bank management what strengths or deficiencies have been found in other areas of the bank. Any interaction with a bank's management before the exam report is finalized, which may be as long as a couple of months, gives the bank additional time to begin correcting any problems found during the exam.

In addition to regular examinations, both state and federal regulators conduct "modified" exams. These exams are performed in lieu of full examinations and concentrate on the specific problem(s) a bank is experiencing. Modified exams are also used to ensure that banks are complying with recommendations made in previous examinations.

Final report. The Examiner-in-Charge is responsible for writing the final report once the exam is concluded. This report is an analysis of the exam and includes comments, individual CAMEL ratings, and a composite rating. After the report is completed, it is submitted to a supervisory examiner who checks for factual errors and justification for the different ratings made by the Examiner-in-Charge.

Following this review, the supervisory examiner drafts a transmittal letter to the bank and, if necessary, a statement detailing any formal or informal action to be taken against the bank. This information, along with the exam report, is then forwarded to the director of the exam division for additional review and approval. There may also be times when the commissioner's approval is added. For example, if action taken against a bank is severe in nature, the commissioner may assess the information and sign off on the report before it is finalized. However, this is not done for every exam. The division has stated that the overall report writing and approval processes take about 35 days.

Once the review process is completed, the transmittal letter, report, and any action statement are sent to the bank's board of directors. A meeting is then arranged between the department and the bank's board to discuss the exam (although prior meetings may have already taken place). Depending on the severity of any action taken against the bank, representatives from the banking department may include the director, assistant director, chief examiner, Examiner-in-Charge, and usually an examiner with less experience. The meeting is designed to point out deficiencies found by the examiners and recommended corrective actions.

Also at this meeting, the bank may question the findings. Although a financial institution may contact the Bank Exam Division about concerns with the outcome of an examination, there is no formal appeals procedure at the state level. However, banks are free to contact the department whenever there is a problem with an exam. Because of this, the department's policy is not to establish a formal appeals process. On the other hand, the FDIC has recently created a formal appeals process for certain situations, but it is not widely used.

The contents of bank examinations are considered confidential records of the banking department, federal regulator(s), and the bank under review. During the exam, examiners are not permitted to reveal ratings to bank management. There is a formal approval process within the banking department that must be followed before the final composite rating and examination report are made known to bank officials.

There are parts of an exam kept by the department and not made known to even bank officials--such as individual component ratings for each of the five CAMEL performance areas and comments regarding the management of the bank. When bank officials receive the final

exam report, general comments about the bank's performance, along with the component ratings and any action taken against the bank by the department, are included. After a bank receives this information, it is required to take steps to alleviate any problems cited in the report.

In addition to the Examiner's Comments and Conclusion Schedule parts of the exam, the Examiner-in-Charge preparing the final exam report must also include the bank's composite rating in the final package sent to the bank. Further, to enable the institution's directorate to better understand and appreciate the significance of the composite rating, the definition of the particular rating accorded must be disclosed to the bank.

Both during and after an exam, state examiners are responsible for storing their workpapers and related documents in their personal laptop computers. The information is then downloaded to a central system maintained at the banking department where it is kept on record.

Enforcement Actions

The Bank Exam Division has several different enforcement actions it can use to ensure banks correct unsound practices identified by examiners. These actions vary in severity depending on the seriousness of the violation(s). The types of enforcement actions available to the department from least to most stringent include:

Board Resolution: This is an informal action taken by the department informing a bank's directors exactly how it wants certain problems to be rectified. Although not a signed agreement, nor legally binding, the bank is to have the resolution adopted at a board meeting and put it into the meeting's official minutes. Once this is done, a certified copy of the minutes must be sent to the department.

Memorandum of Understanding: Like a board resolution, this is an informal action taken against a bank. It is used when the banking department determines that problems of a moderate nature exist with a bank's performance. The document puts a bank's board of directors on notice to make certain corrections, and defines goals and objectives that the department wants the bank to meet. Although definite problems exist, the banking department still has confidence in the bank's management. Similar to board resolutions, memorandums of understanding are not enforceable in court. Each board member, along with the banking commissioner and the FDIC regional director, must sign the document.

Stipulation and Agreement: This is a formal enforcement action taken by the department against a bank. The notice is very specific in defining performance guidelines and implementation schedules. Unlike a board resolution or memorandum of understanding, this action is enforceable in a court of law. Although the department can publicly disclose the information outlined in the agreement, it requires the banks to make such information public.

Cease and Desist Order: This is a formal enforcement action issued by either the banking department or the FDIC when a bank is capital-impaired or has other severe problems. The order outlines a statement of charges and specifies what functions the bank must "cease and desist" from performing, as well as outlining goals, objectives, and performance guidelines. The banking department rarely, if ever, issues such orders due to statutory limitations. Rather, the department usually concurs with cease and desist orders issued by the FDIC. When such orders are issued, the FDIC requires banks to make them public.

Removal of board directors or deposit insurance: Two other enforcement actions that can be taken against a bank are the removal of a member of a bank's board of directors or elimination of its federal deposit insurance. Both the state and the FDIC have the ability to remove a board of director member. However, only the FDIC can terminate a bank's deposit insurance. Once this occurs, the banking department has no practical choice but to close the bank.

Whenever an enforcement action is taken against a bank, the banking department sends a copy of the action, exam report, and transmittal letter to the FDIC and any other federal bank regulatory agency. This is done to ensure that such agencies are kept abreast of the actions taken by state regulators.

In addition to the actions just described, some states grant bank regulators the ability to levy civil monetary penalties to ensure compliance with recommendations made to a bank by the regulator. The FDIC also has the ability to assess civil monetary penalties. At present, however, Connecticut's banking department does not have the authority to levy such penalties.

If there is an enforcement action against a bank, the exam division requires the bank to submit reports showing the steps taken to correct problems identified by the enforcement action. The frequency of the reports depends on the severity of the enforcement action. For informal actions, quarterly reports are normally required. For formal enforcement actions, banks have to report to the exam division on at least a quarterly basis, but most likely monthly reports are required.

Bank Failures

Procedure for closing a bank. Once the Department of Banking decides that a state chartered bank should no longer continue operating, it notifies both the FDIC and the Federal Reserve of its intentions to close the bank. After the closing is approved at the federal level, the FDIC's Division of Resolutions meets with state officials to begin the closure process. It should be noted that whenever a bank is in this situation, state and federal regulators will try various means of recapitalizing the failing bank prior to beginning the closure process.

If recapitalization is not possible, the FDIC's Division of Resolutions is responsible for reviewing the bank's financial condition. At this time, prospective bidders are notified of the pending closure and sale of the bank's assets.

When this process is completed, a bidders meeting is scheduled. By this time, the FDIC already knows who will be participating in the bidding process and has pre-screened the bidders to ensure that they meet certain requirements before being awarded a bid. Several days before the actual bank closing, the FDIC will make an award to the highest bidder. One of the main responsibilities of the FDIC when it awards a bid is to minimize the financial impact to the insurance fund.

After the bid is awarded, the state physically closes the bank to the public and the FDIC is legally designated as receiver of the bank. At this point, the FDIC turns over the deposits and often a portion of the bank's assets as specified in the terms of agreement between the FDIC and the successful bidder. However, there are times when a bank's deposits and assets cannot be sold and the FDIC becomes responsible for them. When this occurs, insured deposits are paid and the Division of Liquidation takes responsibility for liquidating the bank's assets.

CREDIT UNION EXAMINATION PROCESS

In addition to issuing credit union charters, the Department of Banking is also the primary regulator of state chartered credit unions. Currently, there are 85 state chartered credit unions supervised and examined by the Credit Union Division within the Department of Banking. Figure III-2 outlines the process that the division follows when conducting these reviews.

Selection and scheduling of examinations. Similar to bank examinations, credit union examinations are based on the CAMEL rating system. In general, credit unions are selected for examination on the basis of the previous year's examination outcome and date of last exam. The examination selection process is weighted toward picking credit unions with high CAMEL ratings.

Credit unions rated three or worse with assets exceeding \$20 million are also examined by the federal regulatory agency. The department has signed a cooperative agreement with NCUA, the federal regulatory agency, stipulating that all federal examinations of state chartered credit unions are conducted jointly with state examiners. Only one report, the state examiner's report, is issued as the official report. These joint examinations are scheduled six months in advance.

Although it is department policy to examine state chartered credit unions at least once a calendar year, it is not always on a 12 month cycle. For example, an examination was done in January 1990 one year, but the next exam was conducted in June 1991. In this situation, the exam cycle was 18 months.

Examiner assignments. As Figure III-2 indicates, all examination staff assignments are made by the credit union unit director. To ensure that examiners remain detached and impartial, examiners are not assigned to the same credit union for more than three successive examinations. Assignments are based on examiner availability and skill.

The unit director determines how long the examination should take and how many examiners are needed. On average, credit union examinations take about a week to complete with only one or two examiners.

Figure III-2. Key Steps in Credit Union Examination.

Step 1. Credit Union Selection and Examination Scheduling

- A. Division director reviews list of credit unions, dates of last exams, and the most recent CAMEL ratings to determine which credit unions will be examined.
- B. If the CAMEL rating is 3 or worse, a joint exam with the NCUA will be scheduled.

Step 2. Examiner Assignments

- A. Division director decides the amount of time and number of examiners needed to complete exam.
- B. Division director assigns examiner based on [examiner] skill and availability.

Step 3. Pre-examination Preparation

- A. Examiner compiles credit union information package including last exam report and call reports.
- B. Department notifies credit union of examination.

Step 4. Examination

- A. Examiner conducts examination, assigns CAMEL scores, and compares with NCUA national database.
- B. Division director updated on findings and CAMEL scores.
- C. Exit conference with credit union held to discuss examination findings.

Step 5. Final Report

- A. Examiner completes final report, which is reviewed by division director and signed by commissioner.
 - B. Copy of final report sent to NCUA.
-

Actual examination. To guarantee that the key individuals and documents are easily accessible, credit unions are notified approximately one week in advance of examinations. However, there are times when the department only gives one-day notice. As part of the pre-examination process, the examiner reviews the last examination report focusing on the areas that were noted as weak or in need of improvement.

In general, credit union exams are similar to bank examinations. As mentioned previously, credit union examinations are based on the CAMEL rating system. For the most part, CAMEL ratings are the professional judgment call of the examiner. The credit union receives a score in each CAMEL area as well as an overall composite score.

Examinations are conducted on site with examiners utilizing laptop computers to conduct their evaluations. The computers are provided to the department at no cost by NCUA. In addition to the computers, NCUA provides the division with a national database of credit union information. Included in this database are national averages for credit unions in each of the CAMEL areas. At the end of the examination, the examiner can measure how Connecticut credit unions compare with peer averages as well as industry averages.

Throughout the exam process, the examiner periodically communicates with and updates the unit director. Before a final score is established, the unit director reviews the examiners' findings and proposed CAMEL ratings.

Once the composite score is determined, the examiner conducts an exit conference with the credit union. Depending on the examination outcome, the unit director may or may not attend this closing interview. During this conference, the credit union is notified of its rating. At this time, the credit union may make comments on the examination results. If the credit union believes more information could change the examination outcome, the department may take this into consideration. According to the department, unless there is a factual error, changes at this stage rarely occur. Any changes are done prior to the issuance of a final report.

Approximately 10 to 15 days after the exam process is complete, the examiner, with the unit director's approval, prepares a final report for the commissioner's review. A copy of the final report is also sent to the NCUA's regional office.

Follow-up and compliance. Depending on the examination outcome, a credit union may also have to undergo a follow-up modified exam, which monitors progress toward correcting deficiencies and focuses on the areas noted for improvement in the exam report. A follow-up examination is scheduled by the unit director after sufficient time has lapsed since the previous examination to permit the credit union to implement corrective action and to determine results.

Once on site for the follow-up exam, the examiner will review all major problems that existed during the previous contact and determine their present status. In particular, the examiner will focus on financial and managerial problems that could cause failure. At the end of each follow-up examination, a conference is scheduled by the examiner to keep management

informed of the credit union's CAMEL rating and the status of problems along with the recommended corrective action. In seeking compliance, the Credit Union Division has the same enforcement tools available as the Bank Exam Division.

Receivership and mergers. When no other reasonable alternative is available to protect the credit union members, the commissioner may terminate the existence of the credit union by placing it in receivership (C.G.S. § 36-219). A credit union may be placed in receivership if:

- the credit union, through insolvency, gross mismanagement, or neglect, is no longer able to carry out the purpose for which it was formed; or
- the credit union has abandoned its activities and is no longer functioning as a credit union and cannot be terminated any other way.

Table III-1. Credit Union Mergers and Receivership 1988-1992.					
	1988	1989	1990	1991	1992*
Mergers	8	10	3	5	1
Receivership	1	0	1	2	1
* As of June 30, 1992 Source: Department of Banking Annual Reports 1988-91.					

If a credit union is, or may subsequently be, in a doubtful or failing financial condition the commissioner may also authorize a merger. Mergers occur for a variety of other reasons including plant closings, declining field of membership, and as a means for improving and expanding membership services. As shown in Table III-1, the number of credit unions actually being placed in receivership is relatively low. The number of mergers is much higher.

CHAPTER IV

SECURITIES AND BUSINESS INVESTMENTS DIVISION

The primary function of the Securities and Business Investments Division is to ensure that Connecticut's investing public is adequately protected in the marketplace. This is done by regulating the offer and sale of securities and business opportunity programs in the state and licensing the firms and individuals who are in the business of selling them.

In particular, the division supervises: 1) the registration of securities and business opportunity programs for sale in Connecticut; 2) broker-dealer, investment adviser, and agent registration; 3) routine examination of broker-dealer and investment adviser registrants; and 4) enforcement of the Connecticut securities and business opportunity laws. These functions are carried out by four sections within the division: Security and Business Opportunity Registration; Broker-Dealer and Investment Adviser Registration; Examination; and Enforcement.

Securities and Business Opportunity Registration

The Securities and Business Opportunity Registration Section reviews and processes applications for securities, business opportunity, and tender offer registration.

Securities registration. Offers and sales of securities in Connecticut are governed by the Connecticut Uniform Securities Act. The act requires any issuer who proposes to offer and sell securities in Connecticut to register with the Securities and Business Investment Division within the department.

There are two types of registration - registration by qualification and registration by coordination. Registration by qualification pertains to securities that will be offered and sold only in Connecticut. Registration by coordination refers to all other securities that must be registered with the Securities Exchange Commission (SEC).

To register any security with the department, an applicant must submit general information about the issuer including financial statements. In addition, the issuer must also disclose any pending litigation or legal proceeding to which the issuer is a party that can materially affect its business or assets. Furthermore, the issuer must include a summary of information regarding the principal factors that make the offering speculative or one of high risk.

After all required information and documents have been filed, the division staff conducts a disclosure review of the information submitted. If the filing is complete, the department will deem the registration "effective" and offers and sales may begin. In the case of registration by coordination, the SEC also reviews the information and makes a determination of effectiveness. Registration is effective for one year and renewable thereafter. While the registration is in

effect, the issuer must notify the division of any material changes in the application for registration.

Business opportunity registration. A business opportunity is a program that offers investors goods or services needed to start a business. Business opportunity programs can include vending machine routes, distributorships, and franchises (except those with federally registered trademarks). In Connecticut, business opportunity offers and sales are regulated under the Connecticut Business Opportunity Investment Act. Under the Act, any seller of a business opportunity within or from Connecticut must submit a registration application to the Securities and Business Investment Division for its review.

The registration application includes a copy of the disclosure document to be provided to prospective investors, financial statements for the seller, a copy of the contract the seller will require buyers to sign, and sales brochures relating to the business opportunity. Division staff conduct a disclosure review of the application to see if it provides the potential investor with enough information to make an informed decision. Division staff also review the application for misleading or fraudulent statements. After successful completion of the division review, the business opportunity will be registered. At this point, the seller may begin to make offers through Connecticut newspapers, direct mail solicitation, announcements over local radio stations, and participation in area trade shows.

In Connecticut, registration of a business opportunity program does not suggest the state endorses or affirms the merit of the investment. Rather, it means the seller has complied with state laws, and the investment terms have been fully disclosed.

Tender offer registration. Generally speaking, a tender offer exists when one company wants to gain control of another company and it makes an offer to buy all or a certain number of shares of stock in that target company. The company making the offer is the offeror; the target company's stockholders are the offerees. The offer is good for a certain amount of time, during which the target company can recommend that its stockholders accept or reject the offer.

Tender offers are regulated by the Connecticut Tender Offer Act. The law requires anyone making such an offer to file a registration statement with the banking department. As part of the registration statement, the offeror must include copies of all prospectuses, brochures, or other materials that will be disseminated to offerees. This information is reviewed by the state and the SEC to determine whether the offeror has complied with all disclosure requirements. A tender offer automatically becomes effective within 10 days after the date of filing unless the commissioner in his or her discretion decides a hearing is necessary. The commissioner may schedule a hearing if he or she considers it necessary to protect the offerees, the target company's employees or creditors, or to protect any other person's significant interest.

Broker-Dealer and Investment Adviser Registration

The Broker-Dealer and Investment Adviser Registration Section reviews and processes applications for the registration of broker-dealer firms, investment adviser firms, and all of their agents wanting to transact business in Connecticut.

All broker-dealer firms doing business in the state must be registered federally with the SEC and locally with the Department of Banking. In addition, all broker-dealers and agents must register with the National Association of Securities Dealers (NASD), the securities industry's self-regulatory association. Information about brokerage firms and agents is shared by federal and state authorities and NASD through a national computerized registry called the Central Registration Depository (CRD). The NASD maintains and operates the CRD.

Through the CRD system, the state department has access to information about brokerage agents nationwide. This information includes prior employment records, qualifications, licensure status, and current reports of enforcement actions taken against agents registered in other states.

Broker-dealer registration. Prior to selling securities in this state, dealers or issuers of securities must register with the department. In order to obtain registration, an individual must file a written application with the department. The information required in the application is a detailed financial and business record of the person and is to be verified under oath.

When a registration application comes through the banking department a background check is done through the computer system. As mentioned previously, this computer check will reveal what type of license the agent has and whether the agent has had problems in other states.

If the department finds that the applicant is of good repute and character and has complied with the provisions of Connecticut's securities law, it shall register the applicant. The registration is valid for a year and may be renewed.

Investment adviser registration. Connecticut's Uniform Securities Act, which regulates securities broker-dealers and their agents, also requires investment advisers and their agents to register with the state banking commissioner. To register as an investment adviser, an applicant must submit a statement of financial condition and information on his or her educational background and business activities. In addition, the applicant must disclose any disciplinary history.

Unlike the registration of broker-dealers, investment advisers are only required to register with the state. In addition to registration, investment advisers must also maintain business records and make them available for examination by the department. Investment adviser registration must be renewed annually.

Examination

To ensure compliance with the securities and business opportunities laws, the Examination and Compliance Section within the Securities and Business Investment Division conducts periodic examinations of its registrants.

In general, regular examinations are a review of sales practices. In selecting whom to examine, the department gives priority to firms and agents handling controversial product lines such as penny stocks, or targeting a vulnerable client population group, such as the elderly. On average, an examination usually takes two or three days to complete with two examiners. The examiners review the firm's records, policies, and in-house complaint files. The examination results are prepared in a written report. If the examination reveals problems, the examiner discusses the matter with division's assistant director. The assistant director will determine what course of action or sanction, if any, is necessary. The department meets with the firm to discuss the problem and negotiate a solution. A compromise usually entails back fees, costs, and compliance. Once an agreement has been reached, the commissioner is notified for final approval.

Enforcement

The Enforcement Section is charged with handling complaints from investors and conducting investigatory examinations. It also initiates action against persons who have violated the state's securities and business opportunities laws.

Generally, investigations conducted by this section are usually the result of a complaint or tip. As part of the investigation, division staff will take depositions and receive affidavits, and examine books and records. Investigations result in a written report and, depending on the circumstances, a hearing.

The department may take administrative action, such as issuing a cease and desist order, to enforce the state's securities and business opportunity laws. The commissioner may also revoke, suspend, or deny registration that enables a firm or agent to sell investments in the state. In addition, the commissioner may refer cases to the state attorney general for civil prosecution or to the chief state's attorney for criminal prosecution. Referrals are also made to other enforcement agencies such as the SEC. Any action requiring enforcement is referred to the department's legal office with a recommended action by the division. The legal office reviews the issue and makes a determination of the legality of the action.

Division activities. Table IV-1 illustrates the division's activities for 1991. As the table shows, the Securities and Business Investment Division registered 4,468 securities by coordination, and 17 by qualification. Ninety-two business opportunities were registered while no tender offers were submitted. Furthermore, the division processed 17,652 initial registrations for broker-dealer agents and 1,649 investment adviser agents. Initial registrations were also processed for 213 broker-dealer firms and 126 investment adviser firms. In addition to firms,

153 broker-dealer and 30 investment adviser branch offices were registered. In respect to oversight, the division conducted 54 examinations of broker-dealers, while investment adviser examinations totaled 22. In conjunction with the division's enforcement program, 255 investigations were opened on securities and business opportunities. During this same time frame, the division closed 272 investigations.

Table IV-1. Securities and Business Investment Division Activities.	
SECURITY AND BUSINESS OPPORTUNITY REGISTRATION	
Securities	
- by coordination	4,468
- by qualification	17
Business Opportunity	92
Tender Offer	0
BROKER-DEALER & INVESTMENT ADVISER REGISTRATION	
Initial Registration Processed:	
Broker-Dealer Firms (Branch Office)	213 (153)
Broker-Dealer Agents	17,652
Investment Adviser Firm (Branch Office)	126 (30)
Investment Adviser Agent	1,649
EXAMINATIONS	
Broker-Dealers	54
Investment Advisers	22
ENFORCEMENT	
Investigations Opened	255
Investigations Closed*	272
Source: Security Bulletins 1991	
* Number reflects investigations carried from previous year.	

CHAPTER V

CONSUMER CREDIT REGULATION

Consumer credit regulation is the responsibility of the banking department's Consumer Credit Division. The division has three main functions including: 1) licensing particular credit lenders doing business within the state; 2) enforcing state laws and regulations concerning credit practices, particularly with respect to the state's Truth-In-Lending Act; and 3) handling inquiries and complaints regarding consumer credit. The division is comprised of a director, an assistant director, five examiners (one vacancy), two trainees (one vacancy), and three support staff.

Licensing

Licenses are issued by the Consumer Credit Division to the following credit lending organizations:

- small loan companies;
- first mortgage lenders and brokers;
- second mortgage lenders and brokers;
- sales finance companies;
- consumer collection agencies; and
- debt adjusters.

The number of licenses issued in each category for fiscal years 1987-91 appears in Section I in Table I-1.

In order to obtain a license, an application must be filed with the division along with the appropriate fees. Once submitted, the application is reviewed by the director. Background checks of the company's principal officers are made by the state police before the application can be approved. This is done for all applications unless a recent report is on file with the division. Once the background check is completed, and the director approves the application, a license is issued.

The application process is the same for the vast majority of consumer credit licenses issued by the division. However, for collection agency and small loan company licenses, the processes are slightly different. For example, any person desiring to act as a collection agency in the state, whether the business is actually located within the state or not, must submit along with an application and appropriate fees: 1) a \$5,000 bond; 2) a financial statement prepared by a certified public accountant no earlier than 90 days prior to the application; and 3) personal and business histories of the proprietor, each partner, each officer, and the office manager if other than the above. Once this is done, the division director reviews the information and decides whether to issue a license.

For small loan licenses, each applicant must submit an application and fees. In addition, each applicant is also required to:

- 1) give two weeks' public notice in a newspaper of the town of the proposed business regarding the intention to apply for a license;
- 2) provide a brief history of the business owner or partners, directors, trustees, and principal officers;
- 3) provide a brief history of the applicant's participation in the consumer credit field;
- 4) show evidence of a specific capital investment to be permanently maintained at the licensed business; and
- 5) provide reasons demonstrating that the license will be for the convenience and advantage of the community where the business is located.

A license for small loan lending cannot be issued until this information is reviewed and approved by the division director.

License renewal. Consumer credit licenses are effective for one year and expire at different times throughout the year. Before the expiration date, each licensee is responsible for submitting a renewal application and fee to the division before a renewal certificate is issued. Under most circumstances, additional information to the application is required such as proof of continued bonding and documentation showing proof of workers' compensation insurance. The division assists in the renewal process by sending information to license holders prior to the expiration date of their licenses.

The division began automating its license renewal process in early 1992. Information concerning renewals, as well as data concerning new licenses, is being entered into an automated system allowing the division to improve its tracking of licensees. Since renewals are done on a staggered basis throughout the year, the division will complete its first full cycle of entering renewal data in the system in early 1993. All other information concerning licenses is processed manually.

Enforcement

One of the main responsibilities of the Consumer Credit Division is to ensure the enforcement of the laws and regulations governing consumer credit practices throughout the state. Enforcement of one law in particular, the Truth-in-Lending Act, is a primary concern of the division.

The division has several methods it can use to enforce consumer credit laws and regulations. However, it attempts to resolve problems of companies not complying with credit lending standards at the lowest administrative level before more severe penalties are considered.

Investigation/examination. The Consumer Credit Division may investigate or examine a credit lending company to determine if the company is following state credit laws and regulations. All appropriate documents and records of any licensee must be made available to the examiners. To accomplish this, the examiners have free access to the offices and places of business of any licensee. Further, the cost of any examination or investigation conducted by the division is borne by the licensee, except for sales finance companies and consumer collection agencies, which are not required to pay examination costs.

Figure V-1 shows the number of examinations conducted by the division between FY 87 and FY 91. Although the number of exams decreased by 27 percent for the period, exams actually increased by 66 percent between FY 87 and FY 88. However, since then, the number of exams steadily declined to a period-low of 642 in FY 91.

If an examination uncovers wrongdoing on the part of a licensee, the division may take further action. For example, the division has the authority to:

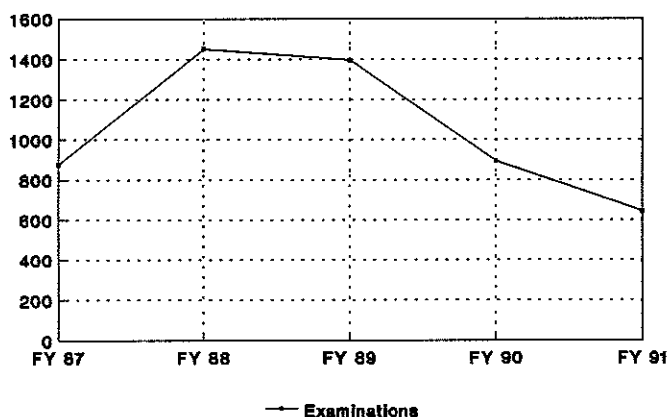
- 1) require a licensee to cease and desist from performing certain practices;
- 2) suspend a license; or
- 3) revoke a license.

Cease and desist order.

Whenever the Consumer Credit Division determines that a licensee is not complying with state credit laws or regulations, it may order the licensee to stop performing specific practices by issuing a cease and desist order. Before this can occur, however, the division must provide the licensee 14 days' written notice of the intent to issue a cease and desist order. After receiving the notice, the licensee may file a written request for an administrative hearing. If this occurs, the cease and desist order is put on hold until the hearing concludes. On the other hand, the division also has the authority to take the issue to court to enforce the cease and desist order.

License suspension. At any time during an investigation, the division may suspend a credit lender's license for a specific time period after proper notification. During the suspension, a licensee may still collect interest or principal payments for any outstanding loans.

**Figure V-1. Consumer Credit Exams
FYs 87-91**



Source: Digest of Admin Reports 1987-91.

License revocation. A license may be revoked by the division if a licensee has:
1) violated any consumer credit law or regulation; or 2) done anything that is not in compliance with the requirements of the original license application. Before a license can be revoked, the division must give the licensee written notice of its intended action and allow the licensee a reasonable time period to be heard.

Fines. The division may levy fines against persons who practice credit lending in the state without the appropriate license or who violate consumer credit laws. However, civil monetary fines may only be levied against someone engaging in secondary mortgage lending without a license. To enforce these fines, the attorney general may take the action to Superior Court.

Truth-in-Lending. The Consumer Credit Division has the responsibility of examining Truth-in-Lending (TIL) practices for all state chartered banks and credit unions, businesses licensed by the division, and retail businesses throughout the state. The law is designed to protect consumers by requiring businesses to disclose credit and leasing terms, thus allowing consumers to compare between various terms and ultimately avoid uninformed use of credit. In addition, the law attempts to promote increased competition among the various businesses engaged in consumer credit lending. Although the state Truth-in-Lending Act addresses disclosure of leasing terms, enforcement of such disclosure is the responsibility of federal authorities.

There is currently a federal act (Consumer Credit Protection Act) similar to the state's Truth-in-Lending Act and Connecticut is one of five states exempt from enforcing the federal law. The reason is because the federal government, through the Federal Reserve Board, allows states to apply for exemption from the federal act if the state law is substantially similar and the state has the means to enforce it. Connecticut has satisfied the requirements of the reserve board and received exemption from enforcing the federal law.

Connecticut is not required to seek annual renewal of its federal TIL exemption. The state, however, annually files a report with the Federal Reserve Board concerning the administration of the state's Truth-in-Lending law. Although not required, the state also sends copies of its TIL examination reports of state chartered banks to the FDIC.

During 1991, the division conducted 560 inspections of the approximately 8,200 creditors subject to state Truth-in-Lending requirements. The businesses investigated included 51 state chartered banks, 70 state chartered credit unions, 314 Consumer Credit Division licensees, and 125 retail businesses.

Creditors found in violation of the state TIL law may be required to: 1) rebate overcharges; 2) issue corrected disclosure statements; or 3) issue additional rights of rescission in cases where such rights were initially improperly administered. In addition, violators are required to inform the division of how violations will be prevented in the future. During 1991, the amount of rebated overcharges totaled \$41,376.

Any person or business who knowingly violates the Truth-in-Lending Act may be subject to a \$5,000 fine, imprisoned for up to one year, or both. The attorney general may also be asked to seek a court injunction against any person or business that performs acts contrary to the TIL law. In addition, the division has the authority to order a lending organization to cease and desist from performing certain functions.

Public Inquiries/Complaints

The credit division is responsible for handling inquiries and complaints from the public dealing with consumer credit. Of the total number of complaints or inquiries made to the division, most are by telephone. However, the division also receives written inquiries. If a consumer wishes more than oral advice regarding an inquiry, the division requires a written complaint unless there is a clear hardship on part of the complainant.

Table V-1 shows the number of inquiries received by the division between FY 87 and FY 91. As the table shows, except for FY 88, the number of telephone inquiries has steadily increased over the five-year period. The number of written inquiries has been more erratic over this period, actually declining during FYs 88 and 89, but rising sharply in the last two fiscal years.

Table V-1. Inquiries Received by Consumer Credit Division: FY 87-FY 91.						
Type	FY 87	FY 88	FY 89	FY 90	FY 91	Overall Percent Increase or Decrease
Telephone	11,879	10,005	12,253	13,482	14,914	26%
Written	1,668	1,273	1,165	1,303	1,982	19%
Source: Digest of Administrative Reports 1987-1991.						

At present, the division has two examiners responsible for dealing with consumer inquiries. Scheduling examiners who handle complaints/inquiries is done on a rotating basis so that the same two examiners are not assigned to this task for a long period of time.

Inquiries or complaints received by the division are resolved either over the telephone or by mail. There are times when field investigations need to be conducted to adequately resolve a complaint. All written resolutions made by the division go out under the division's assistant director's signature.

If the division has no jurisdiction to handle a particular complaint, it refers the complaint to another department or agency having jurisdiction over the subject matter. Referrals are also made if there is concurrent jurisdiction with another agency.

There is currently no automated system within the division to handle inquiries from the public. Written logs are kept for all telephone and written inquiries, and correspondence is stored in files. The division, along with the banking department's Management Information System Division, is currently in the beginning stages of developing its automation capabilities.

CHAPTER VI

FINDINGS AND RECOMMENDATIONS

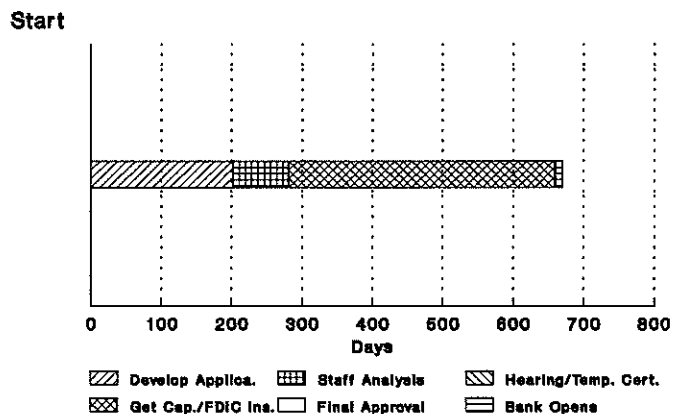
CHARTERING

Analysis. The program review committee staff analyzed 15 of the 27 applications for bank charters filed with the state banking department between 1985 and 1989. The analysis focused on the time required to complete key phases of the application review process, the background of the proposed organizers, the quality of the information supporting the application, and the thoroughness of the review by the panel and banking department staff.

Figure VI-1 shows the average time required to charter a bank. From the first known date of activity on the part of the organizers to the issuance of a charter took an average of 665 days. The time from the submission of the formal application to the granting of a charter averaged 468 days. The time needed to raise capital and obtain FDIC insurance averaged 378 days.

There were a total of 180 organizers in the 15 applications reviewed. Table VI-1 shows the number, typical distribution, and average percentage of bank stock owned by organizers from each occupational type. The primary occupational background of bank organizers was commercial/industrial, accounting for approximately 45 percent of all 180. The second and third most frequently found occupations were financial services (20.4 percent) and real estate (18.2 percent). Organizers typically ended up owning about 20 percent of a new bank's stock.

FIGURE VI-1. CHARTER PROCESSING TIME



Source: Analysis of a Sample of 15 Applications

Analysis of the files revealed that the review of the nonfinancial background of organizers was limited to requests of the state police to check their records. There was no evidence that the personal financial data supplied by the organizers were independently verified.

Outside firms were always used by the organizers to develop the feasibility study and financial forecast required as part of the application. Interestingly, 10 of the 15 feasibility

studies analyzed were done by a single firm and 4 by another. Greater variety existed in the financial forecast area, where eight different firms were used. In all cases, the feasibility studies strongly supported the ability of the proposed geographic service area to sustain a new bank. Likewise, the financial forecasts were always positive.

TABLE VI-1. BANK ORGANIZERS			
Primary Occupation	Number in Sample	Avg. No. Per Application	Avg. % of Bank Stock Owned
Real Estate	33	2	6.5%
Commercial/Industrial	82	5	10.0%
Financial Services	37	2	3.1%
Legal	10	1	.8%
Other	18	1	1.4%
TOTAL	180	11	21.8%

The public hearings held by the panel averaged an hour and 40 minutes, including the time involved to vote on the application. In only one hearing did anyone other than the organizers or their representatives testify. In 11 of the 15 applications reviewed, the vote was taken immediately after the hearing testimony was concluded.

As Table VI-2 shows, in only slightly more than half of the hearings did either the banking commissioner or state treasurer, or their designees, ask any substantive questions related to feasibility or financial presentations made by the organizers. The state treasurer in two-thirds of the hearings did pursue questions related to such issues as the composition of the proposed bank's board of directors and its community service plans. The state comptroller rarely asked any questions at all.

In all 15 applications analyzed, the organizers were granted a charter. When voting, the banking commissioner and the state comptroller or their designees always voted in favor of the organizer's request. On 4 of the 15 applications, the state treasurer either voted against the request, abstained, or did not vote. In none of the 15 cases reviewed was there a written record of the panel's findings.

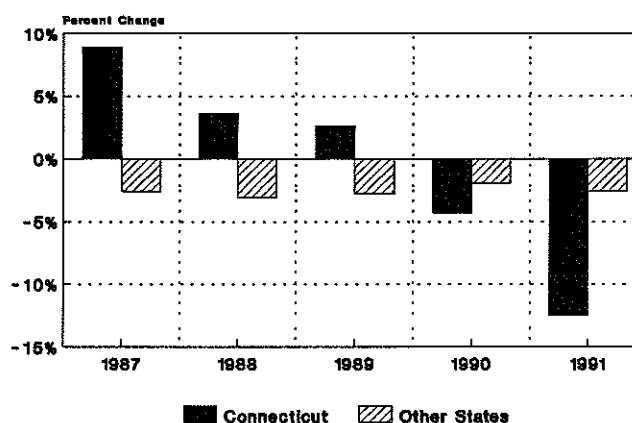
As previously noted, in addition to the 15 applications included in the sample, 22 other state banks were chartered between 1980 and 1990. An analysis of the data indicates the 1980s were not typical with respect to issuing state charters. In fact, of the 121 state banks in existence on December 31, 1990, nearly one-third (37) were chartered in the 1980s. The only other decade in the twentieth century exhibiting a similar level of activity was the 1920s, when the state issued 44 new charters.

TABLE VI-2. PANEL PARTICIPATION IN PUBLIC HEARINGS (n=15)				
		# Times Substantive Questions asked by Category		
Panel	# Times Statutory Member Present	Feasibility	Financial	Other
BANK	13	8	7	5
COMPTROLLER	4	2	1	8
TREASURER	12	9	3	10

The growth in the number of banks in Connecticut in the late 1980s contrasted with the national trend. This is shown graphically in Figure VI-2.

Two reasons are commonly cited to explain the large number of state charters issued during the 1980s. The first centers on the idea that the rapid growth of the state's economy increased demand for bank services beyond that which could be met by existing banks. This argument focuses on the notion that many existing banks turned away from serving small communities in search of larger, more lucrative markets elsewhere.

FIGURE VI-2. RATE OF CHANGE IN THE NUMBER OF STATE BANKS REGULATED



Source: Commissioner's Annual Reports
National Conf. State Bank Supervisors

Speculation is the second factor often referenced as a reason for the increase in demand for state charters. This explanation holds that at least some organizing groups were gambling that the bank they were proposing might at some point become an acquisition target for an in-state bank seeking to expand, or an out-of-state bank if full interstate banking was approved.

Findings. Whatever the reason for the increase, the result has been clear: 13 of the 37 banks chartered in the 1980s failed. The number may go higher as 10 of the remaining 24 are considered problem banks.

In the opinion of the program review committee, the process that produced these results is flawed in several ways. First, the development of the feasibility and financial data, which is critical to evaluating a charter request, is controlled by the applicants and not by those responsible for deciding whether to grant a charter. Thus, the state has the option of either

accepting the data or taking on the burden of disproving it. On the rare occasions when the staff of the banking department raised questions, the data were revised by the organizers, but always remained favorable to the applicant's position.

The objectivity of feasibility and financial studies that are paid for by the organizers of proposed banks is debatable. All 15 feasibility studies in the sample reviewed by the committee staff strongly supported the ability of the proposed bank's service area to sustain another bank. However, the validity of at least some of the studies is questionable in view of the fact that 6 of the 15 banks failed and another 4 are rated as problems. The financial forecasts fare no better. The average capital to asset ratio, required by the FDIC to be 10 percent during this period, was projected to be 28.7 percent in the bank's first year and 18.1 in its second. A review of a limited sample of banks found the actual ratios achieved in the first two years were 11.2 and 7.6 percent respectively.

The program review committee believes a second flaw in the chartering process centers around the three-member panel. The hearings, which are the core of the panel's official activity, are brief affairs averaging less than one hour and forty minutes. As previously noted, a review of the public hearing transcripts revealed that panel members did not ask substantive questions concerning the critical feasibility and financial information presented by the organizers. In addition, the panel did not produce any written findings of fact related to the statutory criteria. Members simply voted.

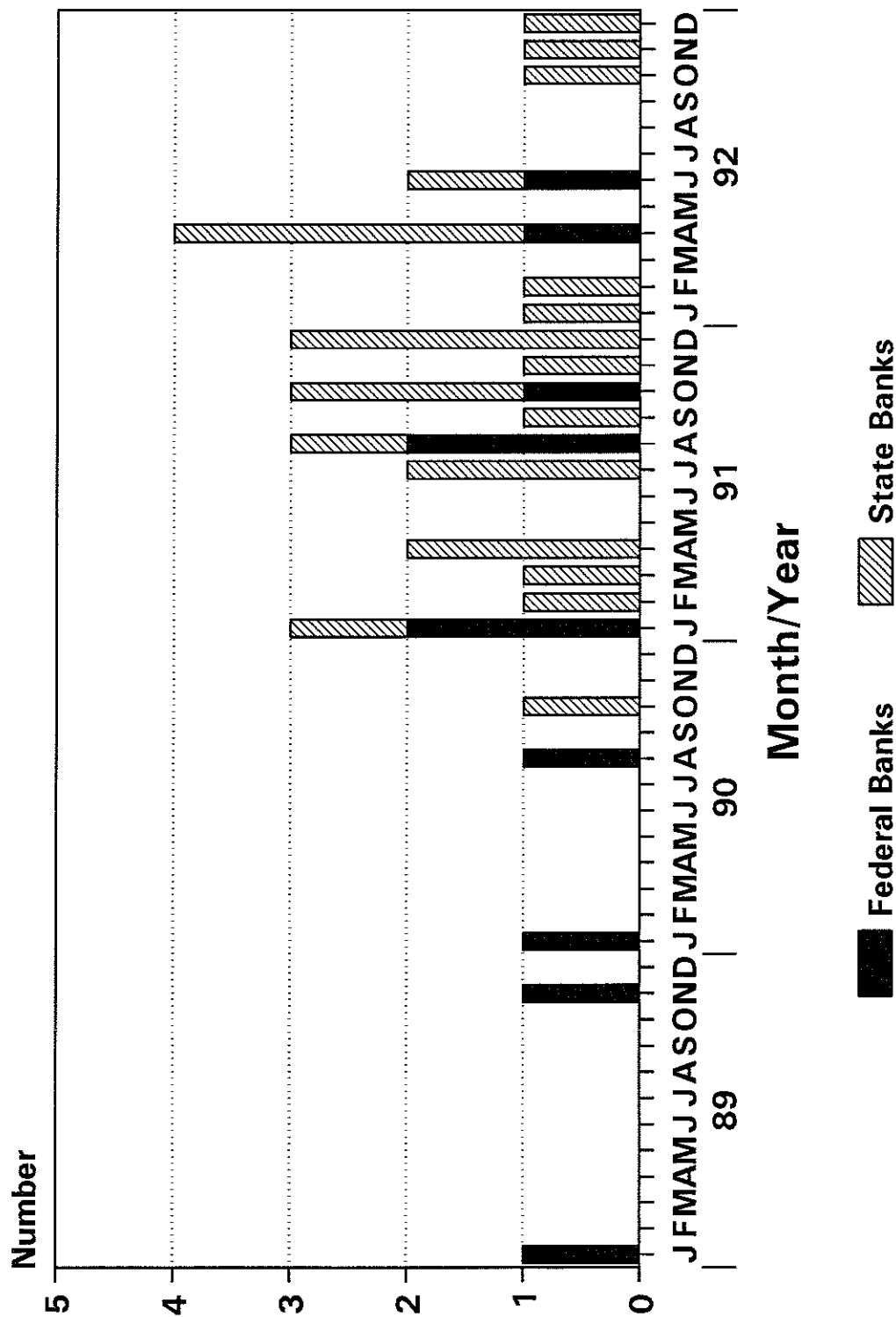
Additional concerns of the committee include the lack of a systematic procedure to independently verify the personal financial data provided by the bank organizers. Similarly, other than a state police records check, there is no formal inquiry into the present and past business dealings and associates of the organizers.

The findings of the program review committee related to the chartering process can be summarized as follows:

- **the ratio of failures (13 as of November 30, 1992) to charters issued in the 1980s indicates that too many banks were chartered; and**
- **the state's chartering process is flawed in that:**
 - **critical information is controlled by the applicants and not the decision-makers; and**
 - **the panel did not demonstrate that it contributed any substance to the process.**

Figure VI-3 shows state and federal bank failures in Connecticut between January 1, 1989, and December 31, 1992. The number of federal bank failures indicates the rapid increase

FAILED BANKS IN CONNECTICUT



Source: Department of Banking

in state charters is not the only reason for the surge in bank failures. Another major contributing factor was the downturn in the economy that began in the late 1980s. In particular, the collapse of real estate values led to a deterioration in the asset quality of many banks that in turn drained their capital bases. The magnitude of the problem can be seen in the rapidly declining percent of capital to total assets shown in Figure VI-4. In general terms, the less conservative a bank had been in its lending practices the greater the problems it encountered as the economy faltered.

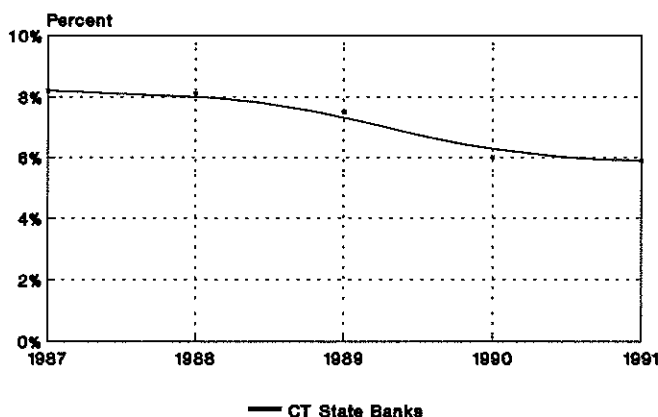
The newly chartered banks were even more vulnerable to the downturn in the state's economy. Confronted with loan requests that had been turned down by other banks as too risky, the new banks, under pressure to grow and produce returns for their investors, often took the risk. In a strong economy, the inevitable loss on some high risk ventures could be offset by returns on other loans. However, in a poor economy, especially one experiencing a rapid decline in real estate values, such losses could not be covered.

The conclusion of the program review committee is that the interaction of the rapid increase in the number of newly chartered banks and the collapse of real estate values caused Connecticut's bank failure rate to soar. Taken separately, neither condition was sufficient to produce the 24 state bank failures that occurred. However, in combination the two factors were devastating to the state's banking industry.

Given that the forces affecting the state's economy are generally beyond the scope of the study, the program review committee focused on the chartering process. Toward that end, the committee recommends:

1. The Department of Banking shall be responsible for obtaining, at the applicant's expense, any feasibility studies and financial forecasts required by the state as part of its chartering process. In no case shall the cost to the applicant, including imposed fees and reimbursable expenses levied by the Department of Banking, exceed \$25,000.
2. The panel shall be required to make written findings of fact on all statutory criteria pertaining to the granting of a state charter.

FIGURE VI-4. TRENDS IN PERCENT OF CAPITAL TO TOTAL ASSETS: FY 87 - FY 91



Source of Data: Department of Banking

3. **The commissioner of the Department of Banking shall be authorized to hold public hearings related to the criteria outlined in C.G.S. § 36-52c and make written findings and nonbinding recommendations.**

The first recommendation is designed to give the state banking department, which is responsible for the safety and soundness of state banks, more direct authority over the granting of state charters. Specifically, the department will have control over the development of the critical feasibility and financial data related to a charter application. The cost of producing the information would continue to be born by the applicants, but for their protection a cap would be placed on the expenses that could be passed along by the state. The requirement that written findings be made would merely place in statute the practice recently instituted by the current commissioner.

The third recommendation is aimed at strengthening the commissioner's authority to review the performance of state banks in meeting the needs of the state's citizens and businesses. The intent is not to micro-manage banks, or to strengthen enforcement of the Community Reinvestment Act. Rather, the recommendation is designed to give the commissioner tools, specifically the threat of public disclosure, to persuade a bank to act differently when the commissioner finds such a course to be in the public interest.

BANK SAFETY AND SOUNDNESS REGULATION

This section focuses on the operation and performance of the department's Bank Examination Division. In analyzing the division, the program review committee concentrated on answering four basic questions it believed were vital to the state's regulation of banks.

1) Does the division have information to properly regulate banks? 2) Does the division collect information on a timely basis? 3) What does the division do with the information after it is received? 4) Does the division react to the information in a timely manner?

As mentioned earlier in this chapter, the committee believes that many of the problems recently encountered by the state's banking industry, especially the surge in bank failures, stem from a combination of a rapidly declining economy and a wave of newly chartered banks. The severity and swiftness of economic deterioration made it extremely difficult for banks to adjust to the changed environment. The problems also challenged a banking department that did not have any experience in coping with a crisis of this magnitude.

Information Available to Bank Examination Division

The program review committee believes the Bank Examination Division has the information it needs to properly monitor and regulate state banks. The information available to the division comes from several different sources and is varied in what it contains. In total, the types of information collected by the division give it sufficient understanding to monitor and

regulate banks' performance. The primary sources of information available to the division are described below.

Bank examinations. The bank exam division, along with the Federal Deposit Insurance Corporation (FDIC), conducts formal exams of the activities and financial condition of state banks. These examinations are detailed reviews of the overall condition of a bank. Of all the sources of information, formal exams, also referred to as full scope exams, provide the division with the most comprehensive and detailed information about a bank's activities and financial condition. In the past, full scope exams have been conducted independently by either the state or the FDIC, or jointly between the two. However, a new approach initiated by the FDIC will virtually eliminate joint exams beginning in 1993.

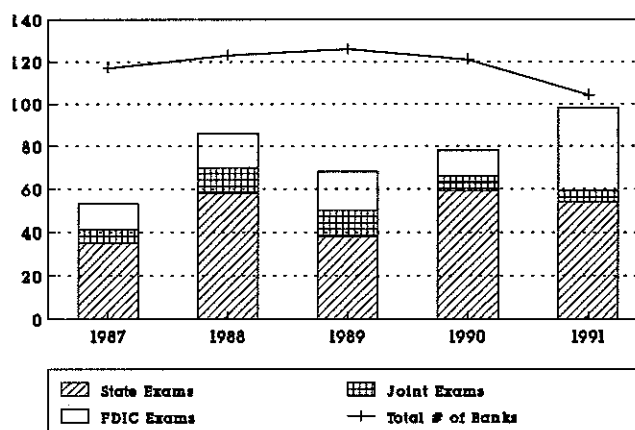
Figure VI-5 provides a detailed look at the number of banks (excluding bank holding companies) examined between 1987 and 1991, as well as the total number of banks operating during those years. As the figure illustrates, the number of exams completed during this period fluctuated. However, full scope exam information was available for a relatively large percentage of banks in any given year; ranging from a low of 45 percent in 1987, to a high of 94 percent in 1991. Annual averages of exams completed for the period were 49 state exams, 19 FDIC exams, and 8 joint exams.

Although not illustrated in the figure, the relationship between the number of state examiners and the number of exams completed is complicated by the interaction between the FDIC and the state in conducting exams. For example, the state could increase the number of examiners, but the total number of exams completed could decline if the FDIC did fewer independent or joint exams.

As mentioned in Chapter III, banks are examined on five key performance components.

These components are identified by the acronym "CAMEL," which stands for capital adequacy, asset quality, management, earnings, and liquidity. Examiners rate each component on a scale of one to five--one being the best rating and five being the worst. Once an exam is completed, the examiners also give the bank an overall or composite rating, using the same one to five scale. It is chiefly these ratings that determine how often a bank is examined and whether or not the division is warranted in taking enforcement action against a bank.

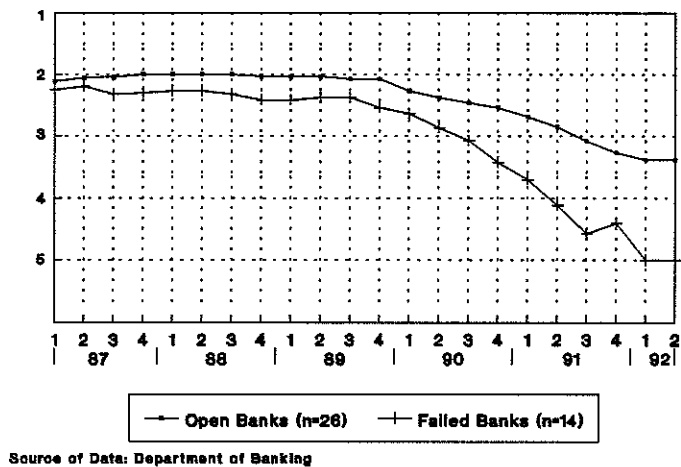
Figure VI-5. Bank Examinations
Calendar Years 1987-1991



Source of Data: Department of Banking

Figure VI-6 compares the average composite ratings of a group of open and failed banks. The averages were computed on a sample of 26 banks that remained open between 1987 and 1992, and 14 banks that failed during that time. Although the figure is based on averages, it illustrates how full scope exam information can be used to identify turning points in the health of a bank, or even a banking system. More importantly, Figure VI-6 shows that exam data can distinguish between banks needing intervention and those that do not.

Figure VI-6. Average Composite Ratings
Calendar Years 1987-1992



Call reports. Call reports are quarterly reports that all state banks send to both the bank exam division and the FDIC. The reports, although not as detailed as full scope examinations, provide information about the financial condition of a bank.

Information from call reports allows continual monitoring of capital and asset data. These data are considered "leading" indicators of how well a bank is performing and, thus, are critical for detecting performance problems within a bank. The call report information also helps both the FDIC and the bank exam division determine which banks should be scheduled for full scope examinations.

Quarterly call report information is also used by the Bank Examination Division partially as an early warning system. It allows the division to take limited action whenever indications arise showing performance problems within a bank. Such action usually includes contacting the bank to discuss problems or scheduling an exam of the bank.

CAEL system. The FDIC has established a system to monitor inconsistencies between a bank's call report information and information obtained from the last full scope examination. The system compares ratios related to a bank's capital, assets, earnings, and liquidity components to those of its peer group. It excludes management, thus the acronym CAEL.

After the ratios are analyzed, new ratings are derived for each performance component. According to the FDIC, the CAEL system is dependable and has at times caused changes in banks' composite ratings.

There are several drawbacks to the CAEL system. First, it only captures information from banks that have had federal deposit insurance for at least 13 quarters. This means that newer banks are not on the system. Second, banks with more than \$3 billion of assets are not included. Third, there is a time delay of between six to eight weeks before the information is made available to the bank exam division. And lastly, only state commercial banks, not state savings banks or savings and loans, are on the system. However, a similar CAEL system for savings banks is planned to begin operating by mid-1993. Presently, approximately 30 state banks are monitored by the CAEL system.

Enforcement action monitoring system. The bank exam division has also developed a system to monitor banks' compliance with any enforcement actions taken by the department. The monitoring system involves requiring banks under enforcement actions to report back to the division on a specified basis regarding their progress toward implementing recommendations stipulated in the actions.

Conclusions. The program review committee finds that the bank exam division collects information needed to properly monitor and regulate state banks, and that the information is appropriate for such purposes. Even though the information comes from several different sources, it nonetheless gives the division the ability to adequately oversee banks' performance. The committee also finds that the information is organized systematically allowing the division to make informed decisions concerning bank regulation.

Timeliness of Information

In addition to collecting information to monitor and regulate banks, the information must be timely. The program review committee believes the information used by the bank exam division is, for the most part, collected in a timely manner.

Onsite monitoring. As mentioned, the division's most detailed information about banks' performance is obtained from full scope examinations. The committee analyzed certain full scope exam data from 1987 through 1992 and found that over this period, the average time between exams to be just under 15 months. A year-by-year average of time spans between exams is shown in Figure VI-7.

The figure shows that the average number of months between examinations of banks increased slightly over the period. For a bank examined in 1987, the average time since its last exam was 13 months. This time only slightly increased for the banks examined in 1988 and 1989.

A significant change in the average time span between exams occurred in 1990. For banks examined during 1990, the average time since their last exams was 17 months. This increase corresponded with several occurrences: 1) economic conditions in the state were rapidly deteriorating; 2) bank composite ratings were beginning to worsen; and 3) state banks were starting to fail. This combination of factors meant that exams were becoming increasingly

complex and examiners were spending more time per exam.

In 1991, the results remained the same as 1990. However, in 1992 the trend seems to be reversing. As Figure VI-7 shows, for the banks examined as of November 1992, the average time since their last exam was just under 16 months.

The program review committee learned that the FDIC recently entered into an agreement with the banking department as to the frequency of exams. The agreement, signed in June 1992, states that banks with composite ratings of four or five should be examined approximately every six months by either state or federal examiners. Banks rated a three, but in unstable financial condition, are to be examined under the same time frames as banks rated four or five. Banks with composite ratings of one, two, or three and considered financially stable, are to be examined annually by alternating agencies.

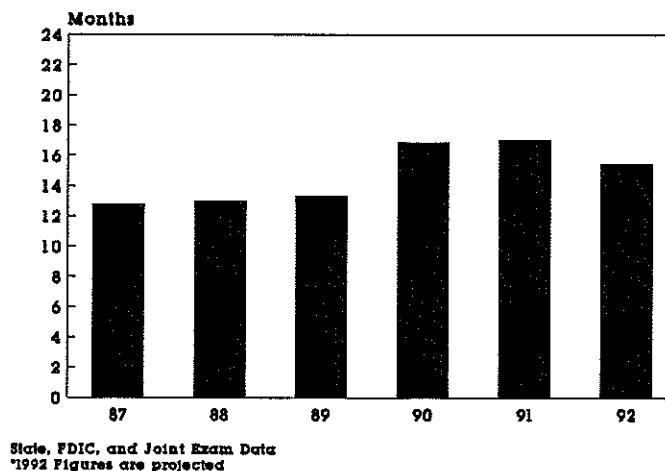
The agreement will not change the fact that whenever one regulator conducts an exam, the other is sent a copy of the final examination report. This ensures that both the state and the FDIC have current exam information for the banks examined by the other regulator.

Offsite monitoring. In addition to full scope exams, the bank exam division receives quarterly reports from banks detailing their income and financial conditions. The division analyzes and tracks the information from these reports allowing it to monitor the performance of state banks.

The division also receives information from the FDIC, as mentioned earlier. This information is used to help the division monitor banks when full scope exams are not conducted. There is a time lag of approximately six to eight weeks to when the information is made available to the division.

Conclusions. In addition to having a solid system to produce information, the program review committee also finds that the system provides this information in a timely manner. The committee finds that these two factors combined give the bank exam division time to detect performance problems banks may be experiencing.

Figure VI-7. Avg Months Between Exams
Calendar 1987-1992*



However, the information received by the division is retrospective and not prospective. Since the banking department is not in the position of micro-managing banks on a consistent basis, the best information available to the division, and also the FDIC, is information about a bank's performance that has already occurred.

Even though the division receives good and timely information, it may still be at a disadvantage in monitoring banks because it has relatively little control over the types of loans or investments banks may make. If a bank makes bad loans or invests in risky ventures, damage to the bank is already done. By the time the division or the FDIC become aware of the problems, it may be too late. The committee believes this is a contributing factor to bank failures. On the other hand, since the division has good and timely information about banks, it may be possible to intervene earlier in the process. The types of intervention used, and their timeliness, are discussed below.

Reaction to Information

The bank exam division has several alternatives when reacting to information it either collects or receives from the FDIC. If the information shows a bank's performance is adequate, the division may decide no action is warranted. If there are indications that a bank is beginning to experience problems, either the division, the FDIC, or both, may decide a full scope examination is needed. If problems are indicated, the division or FDIC may take action.

Enforcement actions. When an exam shows problems within a bank, the division has several regulatory enforcement actions it can take. The types of actions taken usually depend on the severity of a bank's problems. As previously discussed in Chapter III, the actions available to the department from least to most stringent include board resolutions, memorandums of understanding, stipulation and agreement orders, cease and desist orders, and ultimately, elimination of deposit insurance. In addition, a bank's officers or directors can be removed from their duties if the banking commissioner, after a [procedural] hearing, finds just cause to take such action.

Whenever an enforcement action is taken against a bank, the banking department sends a copy of the action, exam report, and transmittal letter to the FDIC and any other federal bank regulatory agency. This is done to ensure that such agencies are kept abreast of the actions taken by state regulators.

Presently, approximately three-fourths of the state chartered banks and savings and loans in Connecticut are operating under some type of enforcement action. Although enforcement actions started becoming prevalent in 1990, data for that year are not readily accessible. Because of this, analysis of enforcement action information began for actions taken in 1991.

Figure VI-8 shows that the memorandum of understanding has been the most frequently used enforcement action since 1991, although its usage by quarter has fluctuated. Use of the stipulation and agreement actions and cease and desist orders, which are the two most stringent

actions, became prevalent in the third quarter of 1991.

Figure VI-9 compares the distribution of enforcement actions issued by the department and the FDIC to the total number of banks existing as of the third quarter of 1992. The increase in the cumulative number of enforcement actions taken against banks is believed to be a direct result of banks' composite ratings worsening, due mainly to the rapid decline of the state's economy in combination with banks not being conservative in their lending and investment practices.

Enforcement actions were also compared with banks' composite ratings. It was found that banks with poorer composite ratings received more stringent enforcement actions. It was also found that banks with composite ratings of one or two (considered good by industry standards), accounted for only 12 percent of all enforcement actions. Of the actions taken against these banks, only board resolutions were used, which are the least stringent actions.

Memorandums of understanding represented 75 percent of enforcement actions taken against banks with a composite rating of three (considered a fair rating). However, when composite ratings reached four or five (considered poor ratings), the types of actions used became more stringent. One-half of all enforcement actions were taken against these banks and combined, these banks received all but one of the stipulation and agreement actions issued, and all of the cease and desist actions taken.

Figure VI-8. Enforcement Actions
Calendar Years 1991-92*

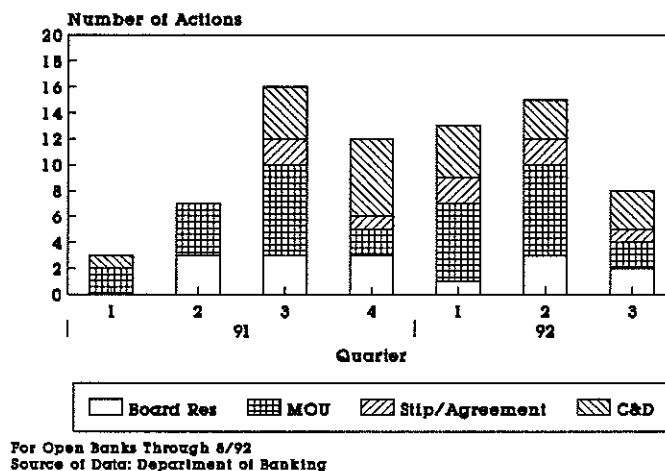
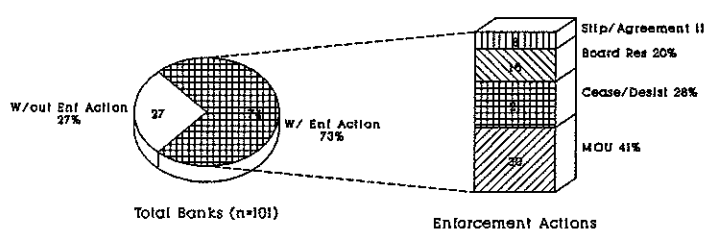


Figure VI-9. Enforcement Actions
Cumulative As of Third Quarter-1992



Conclusions. The program review committee finds that: 1) the bank exam division uses the information it collects from either full scope exams or the several offsite monitoring systems in place; 2) the use of enforcement actions has increased as banks' performance problems have been increasing; and 3) as banks' composite ratings worsen, enforcement actions become more stringent.

Sample Analysis of Examinations

Full scope examinations were analyzed for a sample of 20 banks focusing on three main areas: time frames at certain key points in the exam process; types of enforcement actions taken; and when enforcement actions were taken.

The sample covered exams conducted between 1987 and 1992. It included 10 banks still operating at the time of the review and 10 failed banks. In addition to reviewing exams, the committee studied supporting material, including correspondence between banks and the bank exam division, information regarding enforcement actions taken against a bank, and any other miscellaneous information in the files.

Overall, 78 full scope exams and 2 modified exams were analyzed. The sample included 28 exams completed by state examiners, 19 by the FDIC, 23 joint exams, 6 concurrent exams, and 3 exams classified as "other." Which regulator conducted one exam in the sample could not be determined. Of the exams reviewed, 26 enforcement actions were issued and analyzed.

Analysis of the exams sample showed that the overall average time to complete an exam was 34 days: state exams averaged 28 days; FDIC exams 36 days; and joint exams, in the mid-40s. Additional analysis of exams completed by only state examiners showed the time from the completion of an exam to when the exam information was sent to the bank averaged 77 days. Within this time period, examiners write their formal examination reports, which are reviewed by division management, and a transmittal letter outlining specific deficiencies found in the exam is developed for each report.

A specific requirement of the division is that after a bank receives the final examination report and transmittal letter, it must notify the bank exam division in writing. The committee finds that it took an average of 59 days from the date of the transmittal letter to when written correspondence was received by the division.

The program review committee believes that the time taken by the exam division to prepare final exam reports and issue transmittal letters is too long. Therefore, the committee recommends:

4. **The Department of Banking should establish a goal of 30 days to develop final exam reports and transmit these reports to banks. This goal should be met by the end of FY 93 and continually thereafter.**

Although the recommended time frame for preparing final exam reports may seem aggressive compared to the average time now required, the bank exam division is already aware that efforts need to be made to decrease the time taken to issue these reports. The committee understands that staff resources play a big factor in meeting this goal. However, the division is currently hiring five new examiners, and an additional four to six are being requested. As these examiners become more experienced, the time needed to conduct exams should decrease, and final exam reports should become more timely.

As previously mentioned, twenty-six enforcement actions were taken against the banks that were sampled. A breakdown of the distribution of these actions taken is shown in Table VI-3.

The committee finds that as composite ratings worsened, enforcement actions became more stringent. However, the committee also finds that the time taken to finalize enforcement actions is lengthy. For example, the average time taken to send an enforcement action to a bank was 97 days after the completion of an exam.

TABLE VI-3. Enforcement Actions Found in Exam Sample. (N=26)	
Type of Action	Number
Board Resolution	6
Memorandum of Understanding	9
Stipulation and Agreement	0
Cease and Desist	9
Removal of Director/Officer	0
Deposit Insurance Elimination	2
Source: LPR&IC Sample of Bank Examinations	

Board resolutions, the division's least severe enforcement action, were prepared and sent to banks an average of 62 days after an exam was completed. The average time taken for a memorandum of understanding was 120 days. Meanwhile, cease and desist orders, which are prepared by the FDIC, took an average of 108 days after an exam was completed.

The committee believes the time taken by the exam division to prepare and send enforcement actions should be decreased. Therefore, it is recommended that:

5. **Whenever an enforcement action is warranted, it should be prepared and issued to a bank within 60 days after the exam is completed for that bank. For the purposes of establishing the beginning date for the 60-day limit, an exam shall be considered completed no later than 90 days after it has begun.**

The program review committee has been informed that even though it takes time to develop and issue enforcement actions, banks know what problems are found during exams and what solutions the division is proposing through exit meetings. These meetings are held with bank officials and directors prior to the completion of exams to discuss problems and solutions. There are also times when negotiations between banks and the division take place to determine what goes into enforcement actions and the time frames for implementing recommendations.

Although banks are made aware of problems before enforcement actions are issued, the committee believes this does not substitute for issuing explicit actions. Further, there should be no negotiation between the division and a bank concerning what goes into an enforcement action. The bank exam division is responsible for the regulation of banks' safety and soundness. In that role, whatever course of action it determines suitable for banks should be adhered to and followed.

Aside from how timely enforcement is taken, the program review committee was interested in whether or not enforcement fulfilled its purpose--mainly, getting banks to correct problems found during an exam. An analysis of how many times problems were found on consecutive exams, and how often problems were found on nonconsecutive exams, was conducted. Of the 50 problems identified, 70 percent were still present at the time of the next exam. Thirty percent were found repeated on subsequent, nonconsecutive exams. The program review committee believes this shows that actions taken by the division to ensure banks correct problems after they have been identified by examiners did not work in the vast majority of cases.

Given the division takes stronger actions as the condition of banks deteriorate, but the actions taken do not stop banks from repeating problems, the committee believes that the department lacks the proper authority to require banks to correct problems found during examinations.

Support for this belief is evident in the statutory powers of the banking commissioner. The commissioner may order banks to cease and desist from performing certain practices; however, such orders may not be made public, severely weakening their effect. As it stands now, the department relies on the FDIC to issue cease and desist orders because it can make them public. The department has expressed concern, however, as to the expediency of the FDIC when it comes to issuing such orders.

The FDIC can also ensure implementation of enforcement orders by levying monetary penalties against a bank's officers or directors. The department does not have this ability in the area of bank safety and soundness. It does, however, have this authority in the area of securities

regulation under the Uniform Securities Act. According to the act, a person found to be in violation of the act may, in accordance with the Uniform Administrative Procedures Act, be fined up to \$10,000 per violation.

The program review committee believes enforcement to correct bank performance problems would be greatly enhanced if the banking commissioner was given broader authority to act. Therefore, the committee makes the following recommendations:

- 6. The commissioner of the Department of Banking shall be given the authority to make public any cease and desist order he or she issues against a bank, or its individual directors or officers. Such order can only be made public after any person subject to the order has been heard by the commissioner in accordance with Chapter 54 of the Connecticut General Statutes.**
- 7. The commissioner of the Department of Banking shall be given broader authority to remove any bank director or officer of any institution subject to the commissioner's jurisdiction, if such person(s) is found by the commissioner to be negligent in conducting business at the institution where he or she is a director or officer, or any other banking institution. Such action can only occur in accordance with Chapter 54 of the Connecticut General Statutes.**
- 8. The commissioner of the Department of Banking shall be given the authority to issue a civil penalty, not exceeding \$10,000 per violation, against any bank director or officer who the commissioner finds has violated any law, regulation, or rule under the commissioner's jurisdiction, or any contract entered into with the commissioner. Prior to such penalty, the commissioner shall hold a hearing upon the charges made, unless such person or persons fail to appear at the hearing. Such hearings shall be held in accordance with the provisions of Chapter 54 of the Connecticut General Statutes.**

By broadening enforcement powers, the commissioner's ability to require banks to correct performance problems would be strengthened. The banking department would be less dependent upon the FDIC for issuing cease and desist orders. Also, the time spent communicating back and forth with the FDIC would be lessened, if the department issued its own cease and desist orders. Further, bank directors and officers may now be removed by the commissioner if their conduct at either the bank where they are currently serving or at any other bank warrants removal. Lastly, allowing the department to issue civil penalties in the area of bank safety and soundness would 1) bring it more in line with securities regulation, since both areas would then be monitored using civil penalties, and 2) give it more tools to work with to implement banking laws, regulations, or enforcement actions.

SECURITIES AND BUSINESS INVESTMENTS

The Securities and Business Investments Division within the Department of Banking regulates the offer and sale of securities and business opportunity programs in the state. This is accomplished through mandatory registration and periodic examination of broker-dealers and investment advisers, and enforcement of the Connecticut securities and business opportunity laws.

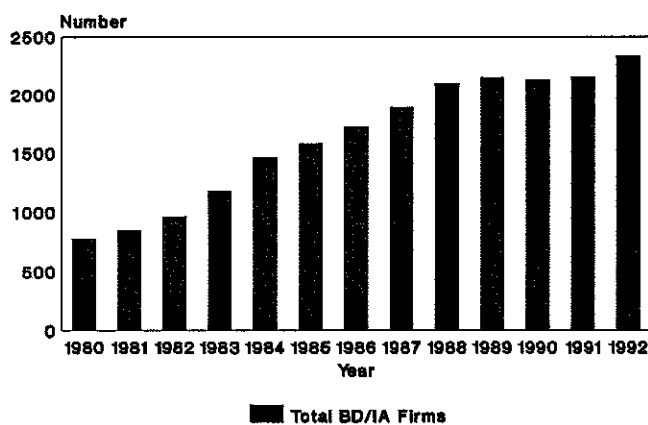
Registration and Examination

Under state law, all broker-dealer and investment adviser firms and their agents must be registered with the Securities and Business Investment Division (C.G.S. § 36-474). As Figure VI-10 shows, since 1980 the number of broker-dealer and investment adviser firms registered with the state has steadily increased to more than doubled over the last 12 years.

As mentioned above, the division also conducts periodic examinations of registered broker-dealers and investment advisers as part of its regulatory function. Figure VI-11 shows the number of examinations performed annually by the division since 1983.

Although the number of examinations conducted by the division fluctuates, as Figure VI-11 illustrates, the general trend has been upward. Since 1983 the number of examinations has significantly increased with a dramatic growth in 1992. According to the division, the growth in the past year is primarily due to a recent increase in staff.

**Figure VI-10. Registrations 1980-92
Broker-Dealer/Investment Adviser Firms**



SOURCE: Securities & Business Investment

The committee analyzed 37 of the 64 regulatory examinations performed by the division in 1991. Seventy percent (26) of the cases reviewed mentioned deficiencies or problems which were resolved without formal enforcement action. The majority of these deficiencies were minor problems involving bookkeeping, renewal of registration, and advertising. In 8 percent (3) of the 37 examinations, enforcement action was taken in the form of a stipulation and agreement or cease and desist order. No problems were noted in 22 percent (8) of the examinations.

The high proportion of examinations uncovering problems may be attributed to good targeting by the division. In selecting whom to examine, the division takes into consideration the date of the last examination, and whether:

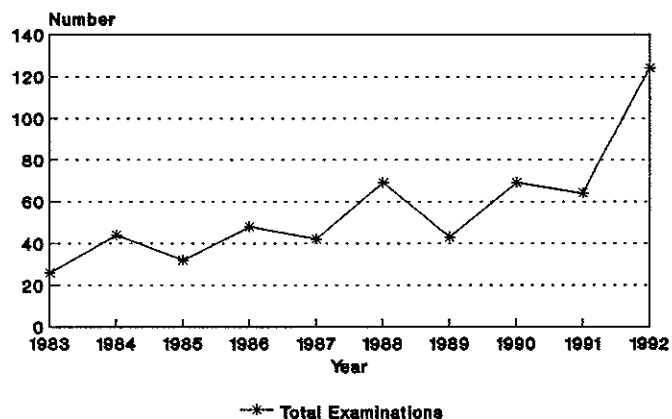
- there is an existing enforcement action against the registrant;
- there were any deficiencies or problems noted on the last examination;
- it is a new registrant; and
- any complaints or tips have been received.

Workload. In addition to the final disposition, the committee also reviewed the files to determine the amount of time and resources needed to complete an examination. The sample revealed 70 percent (26) took one day to complete on site, with the remaining 30 percent (11) of the examinations lasting two to three days. In terms of staff resources, the majority of all exams required only one examiner.

Given the number of examinations conducted (64) and the number of staff assigned to conduct periodic examinations (3), the committee calculated a ratio of examinations to examiners of 21 to 1 for 1991. The time needed to produce an exam was 10 days. However, the dramatic increase in the number of examinations in 1992 has increased productivity to 31 examinations per examiner and reduced the time to 7 days per exam.

Despite the increase in the number of examinations, the committee found the percentage of registrants examined is extremely low. A ratio of examinations to registrants shows that only 2 to 5 percent of all registrants are examined annually. Table VI-4 provides the percentage of broker-dealer and investment adviser firms examined since 1983.

Figure VI-11. BD/IA Examinations
1983 - Period ending August 31, 1992



SOURCE: Securities & Business Investment

TABLE VI-4. Ratio of Broker-Dealer & Investment Adviser Firms to Examinations.			
YEAR	REGISTRANTS	EXAMINATIONS	PERCENTAGE
<i>1983</i>	1,179	26	2%
<i>1984</i>	1,464	44	3%
<i>1985</i>	1,578	32	2%
<i>1986</i>	1,720	48	3%
<i>1987</i>	1,886	42	2%
<i>1988</i>	2,087	69	3%
<i>1989</i>	2,144	43	2%
<i>1990</i>	2,122	69	3%
<i>1991</i>	2,151	64	3%
<i>1992*</i>	2,330	124	5%
SOURCE: Department of Banking documents			
* Period ending August 31, 1992			

Enforcement

In addition to periodic examinations, the Securities and Business Investment Division also investigates complaints from investors and filters out any unregistered activities. Using aggregate data provided by the department, the committee reviewed 255 investigations opened by the division in 1991. The committee analyzed this information to determine the type of complaints received by the division, the timeliness of processing, and the final disposition of those investigations.

In 1991, the division opened a relatively equal number of investigations regarding securities and business opportunities. The median time between the date an investigation was opened and closed was 65 days.

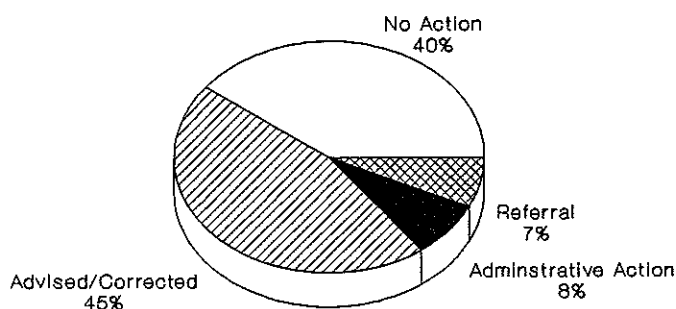
As mentioned earlier, the division has the authority to initiate action against persons who violate the state's securities and business opportunity laws. The department may take administrative action, such as issuing a cease and desist order, to enforce the state's securities and business opportunity laws. The commissioner may also revoke, suspend, or deny registration that enables a firm or agent to sell investments in the state. In addition, the commissioner may refer cases to the state attorney general for civil prosecution or to the chief state's attorney for

criminal prosecution. Referrals are also made to other enforcement agencies such as the Securities and Exchange Commission (SEC).

The outcomes of the investigations reviewed by the committee are presented in Figure VI-12, which shows the division closed the investigation with no action in 40 percent of the cases.

Forty-five percent of the time the division resolved the complaint or problem and advised the party of the Connecticut Uniform Securities Act or the Connecticut Business Opportunity and Investment Act requirements. In eight percent of the cases, the division initiated enforcement actions, and in seven percent the division referred the case to another agency such as the attorney general, chief state attorney, or the Securities and Exchange Commission.

Figure VI-12. Disposition of 1991 Enforcement Investigations



Any investigation or examination requiring enforcement is referred to the department's legal division with a recommended action by the Securities and Business Investment Division. The attorney assigned to the division reviews the issue and makes a determination of the legality of the action.

To determine timeliness of enforcement actions, the committee examined the length of time between when a recommended enforcement action is sent to the department's legal division and when the enforcement action becomes effective. The committee found the median time for issuing an enforcement action was 48 days.

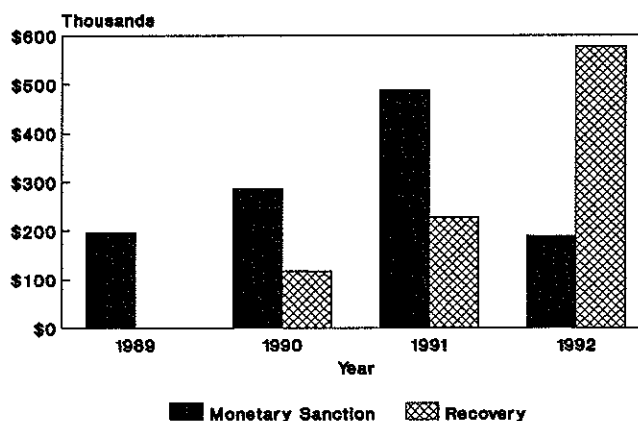
Monetary sanctions. In addition to administrative actions, the Securities and Business Investment Division may also assess monetary sanctions against violators. These sanctions usually entail fines, back fees, and administrative costs. In some instances, the division has also been able to recover funds for investors. The monetary sanctions assessed by the department and the amount of monies recovered are shown in Figure VI-13.

Enforcement activities. Table VI-5 lists the enforcement actions taken by the division in 1991 as a result of periodic examinations, complaints, and investigations.

Table VI-5. Division Enforcement Actions in 1991.	
TYPE OF ACTION	No.
<i>Stipulation Agreements</i>	38
<i>Denial, Suspension & Revocation, Fine Notices</i>	6
<i>Denial, Suspension & Revocation, Fine Orders</i>	1
<i>Cease and Desist Orders</i>	15
<i>Referrals (Criminal/Civil)</i>	8
SOURCE: Securities & Business Investment Division Bulletins 1991.	

As part of its function to protect the state's investing public, the Securities and Business Investment Division has developed several public information services including bulletins, pamphlets, videos, and an annual conference. The development of these educational services have been initiated by the division's director. The division, however, does not have any staff assigned to the development and distribution of educational materials.

Figure VI-13. Sanctions/Recovery 1989-1992 (September)



SOURCE: Securities & Business Investment

The committee finds the director's public education efforts are beneficial, but present two problems. First, this activity may detract from the director's other administrative responsibilities. Second, without the establishment of an identifiable public education program, the division's efforts are not systematic.

Overall, the committee finds the Securities and Business Investment Division's operations are efficient and productive. Resources, not process, limit the division's regulatory activities. For example, given the current number of registrants and examinations completed annually, it will take the department approximately 18 years to complete an examination cycle. Therefore, the Legislative Program Review and Investigations Committee recommends:

9. Staff resources assigned to the Securities and Business Investment Division should be increased. In particular, the division should be provided:

- **more examiners to increase the percentage of registrants periodically examined;**
- **a corresponding increase of legal support staff; and**
- **a person specifically assigned responsibility for developing and administering an education program aimed at registrants and consumers.**

With additional resources, the division should be able to supervise a higher percentage of registrants and decrease the examination cycle. The added legal support is proposed to address two issues. First, it will reduce the backlog reflected in the 48 day time lag for issuing enforcement orders. Second, it is probable that more examinations will produce a higher percentage of enforcement cases necessitating legal action.

Furthermore, a public education coordinator should be able to continue the efforts initiated by the division and establish new public information services for consumers and registrants. The addition of a coordinator will also allow the division director to dedicate his or her efforts more appropriately as administrator.

As mentioned previously, the Securities and Business Investment Division provides 60 percent of the department's revenues through registrant fees, but it consumes less than 20 percent of the department's budget. Specifically, in 1992 the department sought an increase in registration fees producing a projected revenue increase of approximately \$1 million. The committee concludes the department should use the increased revenue to provide more staff resources for the Securities and Business Investment Division.

APPENDIX



STATE OF CONNECTICUT
DEPARTMENT OF BANKING

44 CAPITOL AVENUE HARTFORD, CT 06106



Ralph M. Shulansky

Commissioner

January 19, 1993

Legislative Program Review and
Investigations Committee
State Capitol, Room 506
Hartford, Connecticut 06106

Re: Formal Response of the Department of Banking
to Final Report by the Committee

Dear Sirs:

We received the Committee's final report last week and have had an opportunity to review its findings. We would like to take this opportunity to provide this formal response to be included as part of the published document. Initially, however, I would like to commend the Committee staff for their thoughtful and professional approach to their study of the Department of Banking. We appreciate the complexity of the issues they sought to address in a relatively short time frame, and we fully support most of the recommendations they have proposed.

The Committee concludes, in their Executive Summary, that "the crisis in the state's banking system, which began in the late 1980s, was primarily caused by an interaction between the severe downturn of the state's economy and the rapid increase in the number of newly chartered banks." While the number of new bank charters was one factor in the development of the Connecticut banking problems, we would not characterize it as a primary factor. The report notes two reasons "commonly cited" to explain the large number of new state charters issued in the 1980s: (1) that rapid growth in the state's economy increased the need for bank services; and (2) that the expected opening of Connecticut's borders to full interstate banking encouraged "speculation" on the part of organizers and investors hoping new banks would become acquisition targets. We would like to point out that at the same time, Connecticut's age-old "home office protection" act was being phased out, allowing new banks to be established in towns previously closed to competition.

The peculiar nature of the economic cycle of the 1980s, which reflected a dramatic increase in real estate values followed by a precipitous drop, had a significant effect on banks because so much of their business has historically been tied to loans secured by real estate. In fact, in no small way, the banks actually helped to create the problem that ultimately brought them down by overinvesting in real estate with inflated values.

In addition to the newly chartered banks, there were 19 mutual savings banks that converted to stock form in the 1980s. These banks were suddenly faced with the unusual scenario of too much capital. The pressure on new banks as well as newly converted banks to leverage that capital, especially in

what appeared to be a felicitous economic environment, led to intense competition between banks (and other investors) seeking loans, which led to the making of loans at significantly higher risk levels than had been tolerated in the past. Especially noteworthy was the significant amount of commercial real estate construction lending that was undertaken. The banks that have been closed in the past three years shared several traits: a significantly higher risk profile in their loan portfolio; a tendency to engage in commercial lending without the expertise to identify the attendant risks; and an enthusiasm for taking full advantage of the upswing in Connecticut's economy without the forethought and conservatism necessary to temper that enthusiasm. It appears to us to be sophistic reasoning to take the position that the number of new charters contributed significantly to the number of bank failures. If the initial capitalization requirements had been higher and if management of banks had been wiser and more responsible, we may not have had any bank failures, old or new. In fact, the survival and thriving of a number of newly chartered banks supports our view that, placed in this context, the chartering of new banks did not play a primary role in Connecticut's banking "crisis."

The Executive Summary also states that the Department of Banking "was slow to respond to the banking crisis initially." As the bankers were unable to foresee the dramatic decline in Connecticut's real estate values and its economy, neither were we, nor were the federal regulators. Because our responsibility is to examine our institutions for safety and soundness rather than to instruct them how to operate, we were only able to recognize and respond to the "crisis" after it became apparent. Examination, by its nature, is a trailing indicator of a bank's condition. We have worked with all of our troubled banks to resurrect those that are salvageable, to force some bankers to face the reality of their situation and to demand improvement or discontinuance of unsafe and unsound practices. We have also worked closely with the FDIC to address all of these issues. We feel that the Department responded as rapidly as it could given our role and the dramatic nature of the factors that contributed to the "crisis."

With respect to the specific recommendations set forth in the Committee's report, we have the following responses:

1) We recognize the reasoning behind the suggestion that the Department be responsible for obtaining feasibility studies related to the chartering process, in order to assure an unbiased assessment of the need for a new bank. We have some concern, however, that the idea may be difficult to implement because currently there are a limited number of consultants competent to perform this type of study. We look forward to working with the Legislature in developing a practical approach to this issue.

2) The Department has implemented recommendation #2 in its chartering process over the past year.

3) We reviewed the recommendation that the commissioner have the authority to hold hearings related to any bank's Community Reinvestment Act performance, and we wish to put it in some perspective. The Department currently has the authority and responsibility to examine banks on their CRA performance, to rate the banks and make recommendations as to how they might

improve their performance, and to make the ratings public. We also have the authority to hold hearings related to CRA performance in connection with almost any application filed by a bank with our Department. It is not clear what further need would be served by the commissioner holding public hearings unrelated to applications or ratings. We would, however, if the General Assembly determines there is such a need, implement such legislation in as aggressive a manner as necessary.

4) & 5) The timing issues raised by these recommendations are being addressed internally at this time, and we should report that we were able to develop and transmit final examination reports in under 30 days in the fourth quarter of 1992. The enforcement orders have been issued within 60 days after the completion of an examination, but it is impractical at this time to expect that all exams can be considered completed no later than 90 days after it has begun. Several of our banks have substantial loan portfolios and complex issues arise in the examination, which we should not address briefly in order to meet an arbitrary timeframe. In addition, most banks seek to negotiate the terms of the proposed enforcement order and then must schedule the delivery of the order at a board meeting, which generally occur monthly. We seek to have the information and enforcement action delivered as quickly as possible, but we do not wish to sacrifice accuracy and thoughtfulness.

6) - 8) The Department has proposed legislation to the Banks Committee to address each of these three recommendations, and we agree 100% with these recommendations.

9) Within our current personnel constraints, we have already begun an effort to respond to this recommendation to increase staff resources in the Securities and Business Investments Division. We hope to hire another lawyer to be devoted to securities matters, and we will follow up on the other two areas mentioned. We have the highest regard for the manner in which our Securities Division has been able to accomplish such a high level of enforcement with the small staff it has, and we intend to enlarge it as we can. We should note, however, that the securities industry is self-regulated by the National Association of Securities Dealers as well as having the Securities and Exchange Commission as a federal regulator. Even an increase in our staff devoted to further examinations and enforcement will make only a slight statistical increase in the number of licensees examined.

Again, we appreciate the scrutiny and responses that we received from the Committee staff and found that the review process was overall an educational and positive experience for all of us. In fact, for example, the Securities and Business Investments Division has incorporated the historical information and the standards used by the Committee staff to monitor its performance and improvement going forward.

Thank you for this opportunity to respond to the few issues that we discussed above.

Very truly yours,



Ralph M. Shulansky